CHAPTER-V

Transfer Pricing Methodologies Adopted By The Various Countries Like UK, US, Australia, and its Comparative Study With Reference to India(A comparative study of the Arm’s length principle and other methods followed by the countries)
5.01. INTRODUCTION

Transfer pricing refers to the prices that related parties charge one another for goods and services passing between them. The most common application is the determination of the correct price for sales between subsidiaries of a multinational corporation. These prices can be used to shift profits to tax favored jurisdictions if, in a transaction between a subsidiary in a high-tax jurisdiction and another in a low-tax jurisdiction. The general behavior of tax payers is to engage in this sort of behavior. As there was no limitation to this behavior entire income of Multinational Corporation would be taxed at the lowest tax rate in the world. To prevent these maniac countries set certain tax rules that regulate the prices that related persons can charge one another. The United States transfer pricing systems, as well as almost all other systems, is based on what is known as the Arm’s length Principle, the idea that “the prices charged by related parties to one another should be consistent with the price that would have been charged if both parties were unrelated and negotiated at arm’s length.” This system can work well if the goods and services traded are standardized and commonly traded between third parties for example Oil, steel and other commodities. However as most of the goods and services traded between related parties is non-standardized or unique applying an arm’s length standard becomes more difficult.

Under the United States transfer pricing system, multinationals can effectively allocate profits to low tax jurisdictions based on the mere appearance of activity within a jurisdiction. By strategic planning under the existing system, many multinational corporations have been able to significantly reduce their taxes allowing these corporations to benefit from the public goods provided by the jurisdictions in which they operate including the United States without paying their fair share of tax. This opportunity for exploitation of the U S tax rules exists because the current

172. Most industrialized countries have adopted arm’s length principle, which is standard set forth in the section 482 regulations of US Internal Revenue services. The OECD Transfer pricing Guidelines, most tax treaties and in the model treaties issued by the United Nations and the OECD Organization for Economic Cooperation and Development, which published a Report in 1995 “Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations.(herein after called OECD Guidelines)
Transfer pricing system is administered as a facts and circumstances test with the majority of the information in hands of the multinational corporations (MNC) rather than the government\textsuperscript{174}. Commentators who focus on the shortcomings of arm’s length standard generally propose that taxing authorities impose some form of Formulary apportionment\textsuperscript{175}. Under this Formulary apportionment the income is allocated to the various members of a related group of corporations based on a set of factors such as labor costs in the jurisdiction, sales and value of assets.

However, these formulae methods of taxation will almost certainly lead to inaccurate taxation and very likely, over taxation of multinational corporations, which is itself undesirable as an inefficient solution\textsuperscript{176}. Overall it can be deciphered, that instead of inaccurate and simplistic formula or a largely open-ended system based upon comparables and promoting prolonged controversy as to whether a particular transaction is or is not comparable, a better response would be to adopt a system which attempts to accurately derive an allocation of income based on the best valuation theories available, such system would have the benefits of both a formulary apportionment system and the arm’s length standard.

In 1979 the OECD published a comprehensive survey entitled ‘Transfer pricing and Multinational Enterprises’ where it is reflected that the arm’s length standard is generally accepted by all member countries of the OECD, as well as most other industrialized countries in the world. Over a period of time it has attained the status of \textit{Jus cogens} under International status where rules and regulations of International law govern.

\textbf{5.02. Transfer pricing methodologies}

Two approaches to transfer pricing have received almost all of the focus in the literature. Most industrialized countries have adopted the \textit{Arm’s length principle}\textsuperscript{177} which is the standard set forth in the section 482 of IRS Regulations\textsuperscript{178}.

\begin{itemize}
\item \textsuperscript{174} US International Transfer pricing \textit{op cit.} (2003)p.203
\item \textsuperscript{175} Avi-Yonah \textit{“Formulatory Taxation in the North American Free Trade Zone”} reported in Taxation Law Review no 49 (1994) p. 691
\item \textsuperscript{176} Robert Ackerman & Elizabeth chorvat\textit{“Modern Financial Theory and Transfer pricing”} 10 Geo, Mason Law Review (2002) p. 637
\item \textsuperscript{177} The authoritative statement of the Arm’s length principle is found in paragraph 1 Article 9 of the OECD Model Tax convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries. Article 9 provides: “(When) conditions are made or imposed between…. Two (associated) enterprises in their commercial or financial relations which differ from those which would be made between
\end{itemize}
The OECD Guidelines for transfer pricing, most tax treaties, and in the model tax treaties convened by the United Nations and the OECD. *The arm’s length standard is almost universally accepted because it is thought to be model under which revenue authorities are most likely to calculate the proper amount of income subject to taxation within their jurisdiction*\(^ {179}\). By incorporating the separate entity concept, the arm’s length principle places related and unrelated enterprises on an equal footing for tax purposes, avoiding the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either form of entity.\(^ {180}\) In the public marketplace gains to trade are divided by arm’s length bargaining. The essence of the transfer pricing problem is that there is no public marketplace, gains to trade are divided by arm’s length bargaining. The essence of the transfer pricing problem is that there is no public marketplace when trade occurs between related parties. Arm’s length principles, properly applied, require economic reality to govern the determination of the transfer price. Simple allocation techniques such as formulary apportionment do not account for the value properly allocable to nontraditional assets such as intangibles (trade secrets, processes, or proprietary methods) or contract rights or risks associated with both the traditional and nontraditional assets of the business entity. The process of Transfer pricing is described in the chart mentioned in the process can be understood by virtue of following chart in *Table 1*
### TABLE No 1

<table>
<thead>
<tr>
<th>Identification of Intra Group Transactions</th>
<th>FAR Analysis</th>
<th>Identification of comparable Transaction</th>
<th>Establishing comparability Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustment</td>
<td>Determination of ALP</td>
<td>Selection of most appropriate</td>
<td></td>
</tr>
<tr>
<td>Documentation</td>
<td>Return filing</td>
<td>Transfer pricing Assessment</td>
<td></td>
</tr>
</tbody>
</table>

#### 5.03. Arm’s length Standard: Current Transfer pricing methods

*Income for transactions between related parties is the Arm’s length standard. The concept of arm’s length result of a controlled transaction is assumed to be that result which would have occurred between uncontrolled taxpayers in the same transaction under the same circumstances.* Because, identical transaction can rarely be identified, the arm’s length standard must typically be applied using unrelated party transactions under similar or comparable circumstances as benchmarks. These unrelated-party transactions are referred to as comparable transactions. This current method is divided into two categories:

1. Traditional Transaction methods

2. Profits-based methods

These Traditional transactional methods compare the price charged in controlled transaction with prices charged in comparable transactions undertaken between unrelated parties. These methods are widely recognized in all countries for
determination of Arm’s length price. The methods that fall under this category are as under,\(^\text{181}\)

1. Comparable uncontrolled price method (CUP)(this method is relied on prices in comparable transactions between or with unrelated third parties);

2. Comparable uncontrolled transactions (CUT)(in case of intangibles transfers);

3. Resale Price Method (RPM)(this method is used when ultimate sales price to the arm’s length third parties is known and in this case the transfer price is determined by reducing the price by a reasonable markup);

4. Cost Plus method (CPM)(this method is applied when the costs incurred for supplying a product are known the transfer price is determined by adding a reasonable markup to the cost);

5. Profit split method;

6. Transactional net margin method.

The first three methods mentioned above are commonly known as “traditional methods”. Although the taxpayer is given the right to choose any method or any combination of the methods above, the emphasis should be on arriving at an arm’s length price. The Data based on comparable unrelated transactions is presumed to provide the most objective measure for judging whether the results of controlled transactions are arm’s length. However, these methods require information about comparable transactions between unrelated parties that is usually not publicly available. In debating the 1986 Tax Reform Act in United States the congress noted the “recurrent problem of the absence of comparable arm’s length transactions between unrelated parties and inconsistent results of attempting to impose an arm’s length concept in the absence of comparables”\(^\text{182}\).

The methods mentioned in 5 and 6 are commonly referred as “Transactional profit methods” be used only when traditional methods cannot be reliable applied or exceptionally cannot be applied at all. In general the Traditional Transactional methods are theoretically superior to profits-based methods for implementing the arm’s length standard, detailed information regarding comparable transactions is not

\(^{181}\) Wahi V S op.cit., p. 133

always readily available\textsuperscript{183}. Where no reliable data regarding comparables are available, or where adjustments cannot provide for sufficient comparability between controlled and uncontrolled transaction\textsuperscript{184} transactional methods are no longer feasible and profits based methods are allowed. The method that requires the fewest adjustments and provides the most reliable measure of an arm’s length result is preferred always. This will reduce the scope and nature of future disputes. This will depend heavily on the availability of comparable data. The detailed picture of the Traditional Transaction methods is as under Table -2.

\textbf{Table -2}

<table>
<thead>
<tr>
<th>SI No</th>
<th>Transactional Methods</th>
<th>Applications</th>
<th>Suitability</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CUP</td>
<td>Most direct and reliable \nClose similarity of product is Fundamental</td>
<td>Suitable for sale of goods or commodities,\nProvisions of service,\nTransfer of intangible,\nLoans and other financial transactions</td>
<td>USA is affirmed their preference for this method in their Administrative Guidelines. In India there are no specific guidelines regarding criteria to choose a particular method and there is no provision in respect of priority for any particular method. On the basis of approach followed by OECD and other countries, in India also CUP method is preferred for determining arm’s length price though limitation of data of comparable transaction restricts its use in many cases</td>
</tr>
<tr>
<td>2</td>
<td>RPM</td>
<td>Testing Distributor’s Transfer prices \nSimilarity of functions over</td>
<td>This method is generally used in transactions involving selling and distribution</td>
<td>US regulations like the OECD Guidelines recognize the application of RPM only in case of transactions involving a</td>
</tr>
</tbody>
</table>


\textsuperscript{184} Bausch & Lomb Inc. v. Commissioner, 92 T C 525 (1989) held that “if an uncontrolled transaction can be found that involves the transfer of the same product under substantially the same circumstances as in the controlled transaction, application of the CUP method, which is called an exact CUP should be straightforward. However, the use of an “inexact” CUP where differences are minor and have a definite and reasonably ascertainable effect on price for which adjustments can be made can still provide a direct and reliable measure of arm’s length price”
<table>
<thead>
<tr>
<th></th>
<th>products functions wherein the reseller /distributor does not add significant value to the product through use of tangible or intangible property.</th>
<th>resale of tangible property and not in cases involving a resale of service as provided in the Indian legislation.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Inventory turnover rate</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. Contractual terms</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Sales and marketing costs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Foreign Currency risks</td>
<td></td>
</tr>
</tbody>
</table>

|   | Suitable for manufacturing activity Direct & indirect costs of production | Suitable for transactions relating to supply of semi-finished goods Contracts where associated enterprises have concluded joint facility agreement or long-term buy and supply arrangement Contract for supply of specialized goods and such as defence equipment or for execution of turnkey project | Many countries like USA, Korea Finland apply cost plus method in the order of priority after resale price method. If otherwise conditions to apply this method are found suitable. In India this method is usually applied in case of transactions relating to supply of finished or semi-finished goods and in case of contract manufacturing. In contracts for provision of services, this methods is preferred if data of comparable transactions is available in public domain |

### 5.03.1. Comparable uncontrolled price method (CUP) Method

This method compares the price charged or received in controlled transactions with the price of comparable uncontrolled transactions. It is price for identical or nearly identical property traded between the two independent parties under the same or similar circumstances. This method assumes that a known comparable uncontrolled price exists for the sale or purchase of the same or similar goods to or from independent parties.

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185 Wahi V S “Transfer procedure and documentation an Indian and Global analysis” op.cit., p. 134
1. The CUP method is ideal only if comparable products are available or if reasonably accurate adjustments can be made to eliminate material product differences. Other methods will have to be considered if material product differences cannot be adjusted to give a reliable measure of an arm’s length price.

2. The CUP method is the most direct way of ascertaining an arm’s length price. It involves the direct price comparison for the transaction of a similar product between independent parties.

   When there is difference between prices of controlled and uncontrolled transactions the price charged in controlled transaction is substituted by price in uncontrolled transaction along with adjustment to account for the differences in two transactions. The price so arrived at is considered as the arm’s length price of the controlled transaction.

Paragraph 2.16 of the OECD guidelines, 2010\textsuperscript{186} refer the CUP method as most suitable method in considering the controlled and uncontrolled transactions. Several countries consider CUP as preferred method though the law does not express priority of this method over the other methods like Denmark, Canada, and USA in their administrative guidelines. This compares the transfer price to a comparable transaction between unrelated parties. The key is comparability. The two transactions being compared might not be the same in all respects. Adjustments must be made for any difference between the transactions. If the differences are not material, or if the effect of any material differences can be quantified, then this method often results in the best estimation of arm’s-length price. The regulations list eight factors that often cause differences between transactions.

\textsuperscript{186} Para 2.16 of the OECD Guidelines 2010 reads as “in considering whether controlled and uncontrolled transactions are comparable, regard should be had to the effect on price of broader business functions other than just product comparability. Where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability”
a. Quality of the product;

b. Contractual terms, (e.g. scope and terms of warranties provided sales or purchase volume, credit terms, transport terms);

c. Level of the market (i.e. wholesale retail etc);

d. Geographic market in which the transaction takes place;

e. Date of the transaction:

f. Intangible property associated with the sale;

g. Foreign currency risks; and

h. Alternatives realistically available to the buyer and seller.

**USA regulation:** Allocation of income or expenses of controlled transactions is made by using any one of the methods prescribed namely, CUP, RPM, Cost-plus method; comparable profits method (CPM) and other specified methods. U.S. Regulations under section 1.482-3(b) (1) the arm’s length result in a controlled transaction is made by reference to the amount charged in a comparable uncontrolled transaction. The main criterion for assessing the degree of comparability between uncontrolled and controlled transaction is the similarity of the products. If the differences are material in nature for which adjustments cannot be made under this method

US law requires taxpayer to select best method to test the arm’s length character of the transactions. The best method is the method which under facts and circumstances of transactions under review provides the most accurate and reliable measure of an arm’s length result. The rule is applied not only for selecting particular method compared to other potentially applicable methods but also for developing transfer pricing methodology. E.g., selection of comparables Revenue authorities may determine whether arm’s length price was reasonable or not from all the facts and circumstances of a case. For this purpose it may take into consideration the degree of comparability between the controlled and uncontrolled transactions, data quality, critical assumptions and number and accuracy of the adjustment required under each method. The comparability factors include analysis of functions performed, risks assumed, contractual terms, and characteristics of the property transferred or the services provided. The rules contain guidance for evaluating the comparability of uncontrolled to controlled transactions. Degree of similarity and
adjustments that may be required for a transaction to be considered comparable is prescribed.

The basic principle of the CUP method is to assess the differences between transactions among related and unrelated parties. This is probably the most reliable and direct method. But its great difficulty is that many groups of companies are so unique that it is hardly possible to find any comparable transaction, let alone sufficient comparable uncontrolled transactions to use as a basis. Another complicating factor is the differing view that tax administrations and business frequently have in practice regarding genuine comparability.

CUP can be either

a. Internal CUP or

b. External CUP

Internal CUP is available, when the tax payer enters into a similar transaction with unrelated parties, as is done with a related party as well. This is considered a very good comparable, as the functions performed processes involved, risks undertaken, and assets employed are all easily comparable- more so, on “one for one” “two for two basis. The tax payer or any other Associated enterprise of a the group buys or sells similar goods, in similar quantities and under similar terms from/to an independent enterprise in a similar market can be treated as internal CUP.

CUP method can be internally comparable; if an enterprise does have a similar product manufactured and sold to a third party as well as transfers the same type of product to associated enterprises. This is very much accepted globally by the Transfer Pricing Officials, as there is minimal adjustment to be made for the geographic conditions, volume off-take, Patent and distribution networks. The Internal CUP can be represented in figure in Table 3.
(Description: Price at which the sale is made to the third party is the Internal CUP) the price at which Indian subsidiary company purchases goods from unrelated entities in US would be considered as Internal CUP for the purpose of application of Comparable Uncontrolled price method

External CUP: External CUP is available if a transaction between two independent enterprises takes place under comparable conditions involving comparable goods or services. An independent enterprise buys or sells a particular product, in similar quantities and under similar terms from to another independent enterprise in a similar market. The under mentioned chart in Table -4 explains the comparability of the transactions between two parties who are related to each other when compared to an unrelated party.
5.03.2 CUP DATA

Comparable data means data of comparable prices of uncontrolled transactions maintained in public domain. Many transfer pricing databases or official publications regularly maintain and publish information about prices of uncontrolled transactions of similarly traded goods and services. When there are no differences between controlled and uncontrolled transaction or differences are of minor nature for which accurate adjustments can be made the data is called exact CUP. For example, a transaction of sale of television or fridge would be a case of exact CUP if same product is sold in open market conditions to independent enterprises. On the contrary if the difference between controlled and uncontrolled transaction is more than that of minor nature, for which reliable adjustments cannot be made data is called inexact CUP. In case of inexact CUP reliability of using CUP method is affected because of major differences in the nature and characteristics of transactions.
5.03.3 **DATA SOURCE**

Information in this regard can be obtained from the books of accounts and other documents pertaining to such transactions and available internally. Data of prices of transactions entered into by independent parties constitutes external CUP. Taxpayer can use published data of stock exchange or any other quotation media. Generally it is difficult to use data of public exchanges and quotation media except in transactions involving transfer of products, where quotations are given by commodity exchanges like agricultural products. The main source of external data consists of the price list of companies, websites trade directories and Government publications.

5.03.4 **INTERNAL CUP**

Internal CUP means the data of transactions of tested party entered into with unrelated parties. When Indian company supplies goods in another country to a party which is not a related enterprise; these transactions can be used for comparison of price of controlled transactions of the company. Since CUP involves exact comparison of transactions, the similar transaction entered with third party other than associated enterprise can be best evidence of the transaction. In order to establish comparable uncontrolled price using self-comparable, taxpayer should show that economics of transactions with associated enterprises are substantially the same as those of the independent transaction. However minor adjustments can be made in respect of few items like freight and duty differences if their effect on price is reasonably quantifiable. In *Birla soft (India) Ltd vs. Deputy Commissioner of Income Tax*[^187] in the case, the assessee engaged in business of software development and related services. The company entered into international transaction with associated enterprises. It applied TNMM (Transnational net margin method) by comparing operating margins earned from rendering software development and related services to associated enterprises with operating margins earned for similar services to unrelated parties. The TPO rejected the method for the reason has not maintained segmental accounts and not reported the same in audited financial statements. Tribunal held that assessee was justified in undertaking internal benchmarking exercise on a standalone basis by placing on record the workings of operating profits.

[^187]: No 9 (2011) 263 Taxman.com Delhi
earned from international transactions and comparing it with transaction with unrelated parties. The revenue from transactions with associated enterprises and non-associated enterprises was known and taken actual figures. The determination made by the assessee was on scientific basis considering defined allocation keys.

It was held that the methodology adopted by the assessee was accepted and the Transfer pricing officer was directed to determine arm’s length price on the basis of internal comparison of net margin earned by the assessee from international transactions with unrelated parties. In *In VVF Ltd vs Dy.CIT*¹⁸⁸ it was held that the preference should be given to internal CUP over external CUP for comparability of transactions. The comparable uncontrolled price method seeks to ascertain arm’s length price by taking into account prices at which similar transactions have been entered by aassessee with unrelated parties which constitutes internal CUP. The fact is internal CUP provides better comparability as compared to external transactions because the conditions of the market are similar. It was held by the ITAT that the transaction of lending money by the assessee by way of interest free foreign currency loan to its foreign subsidiaries, should be compared with a company lending in foreign currency to unrelated party. It was observed that the ICICI Bank had advanced foreign currency loan to the assessee at LIBOR plus 3%. This can be taken as internal CUP as the credit rating of subsidiary merges with the credit rating of the Parent. The comparison of interest should not be benchmarked with the cash credit @ 14% given to the Assessee.

There cannot be universal rule for giving preference to internal CUP over external CUP as it would depend upon the facts of the case and availability of comparables in public domain. In the case of GhardiaChemical Ltd vs DY.CIT¹⁸⁹ the Tribunal held that determination of arm’s length price on basis of internal CUP was not justified in preference to external CUP method used by the assessee where reliable data was available

*In another case, DCIT vs. M/s 3 Global Services Pvt Ltd*¹⁹⁰ *The Mumbai ITAT held that the per hour billing rate published by the National Association of Software and Service companies (NASSCOM) for a specific business segment as an “external

¹⁸⁸ ITA 673, Mumbai (2008)
¹⁸⁹ (2010)35 SOT 406
¹⁹⁰ ITA NO. 1812/MUM/(2009)
"CUP" in determining the arm’s length price. In this case the TPO (Transfer pricing Officer) rejected the CUP method selected by the Assessee and chose TNMM (Transaction Net Margin Method) as the Most appropriate Method selecting five companies operating in various segments such as KPO, Content Development, Data Conversion, Software and the like, These segments are totally different from the voice based customer support services performed by the Assessee. On appeal, the CIT (A) agreed to assessee’s contention and rejected the TNMM method proposed by the TPO stating that the comparables selected do not belong to the Voice Based BPO services. On this Revenue went on appeal to the ITAT. The ITAT categorically stated that per hour rate of a specific sub-segment of the industry is considered as the CUP and it cannot be selected as comparable for applying the TNMM.

5.03.5 Arm’s Length price under CUP method

The Indian Income Tax Act, 1961 Section 92C (2) Rule 10 B (1) (a) provides that arm’s length price in relation to international transaction shall be determined by the most appropriate method, in the manner as may be prescribed. Rule 10B (1) (a) of the Income Tax Rules prescribes the manner of computation of arm’s length price in case of comparable uncontrolled price method. It is as under:

a. The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

b. Such price is adjusted to account for difference, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market

c. The adjusted price arrived at under sub-clause(ii) is taken to be an arm’s length price in respect of the property transferred or services provided in the international transaction©(please refer Appendix XI-A & XV-A for process of CUP method)
The Institute of Chartered Accountants of India in its Guidance Note has recommended the under mentioned steps for computing the arm’s length price under CUP method.

The ICAI methods are similar as stated above from a to c of Indian Income Tax Act, 1961 Section 92C (2) Rule 10 B (1) (a) and in addition one more step in identifying the CUP method is:

“If the price charged in international transaction is lower than the arm’s length price or the price paid in the international transaction is higher than the arm’s length price then the adjustment is to be made to the price charged or paid in the international transactions by the amount of such variance.”

5.03.6 Applicability of CUP method:

Though Comparable Uncontrolled Price appears simple in concept, it is very difficult to apply it in practice. The CUP is believed to be the most reliable/best method, if one could identify and map it. The examples where the CUP can be applied without much difficulty are:

a. Interest payment on a loan;

b. Royalty payment;

c. Software development where products are often licensed to a third party;

d. Price charged for homogeneous items like traded goods.

5.03.7 Comparability Factors

The OECD Model on traditional transaction methods, while referring to the CUP method, clearly states that it is very difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price. A minor difference in the property transferred in the controlled and uncontrolled transaction could materially affect the price even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin. This can be explained through illustration in the following Table-5.

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Table-5

Tax payer A, an MNE sells 70% of its product to an overseas associated company at a price of Rs. 100 per unit. At the same time, the remaining 30% of that product are sold to local independent enterprise C at Rs. 150 per unit.

\[
\begin{array}{|c|c|}
\hline
\text{Transfer price 100} & \text{Rs.100} \\
\hline
\text{MNE A} & \text{Overseas Associated Company B} \\
\hline
\text{Rs 150} & \text{Independent enterprise C} \\
\hline
\end{array}
\]

\[\text{[Description:-The products sold to “B” and C is in fact same. The transaction between “A” and “C” may be considered as a comparable uncontrolled transaction. However, a functional analysis of “B” and “C” must first be carried out to determine any difference. If there are differences adjustments must be made to account for these differences. Adjustments must also be made to account for different market conditions since “B” and “C” is located in different countries and for product quantity discounts since volume of sales to “B” and “C” are not the same. Assuming that reasonable accurate adjustments can be made to eliminate the material effects of these differences, then the CUP method may be applied using the unit price of Rs. 150 as a comparable arm’s length price. ]}\]

The Tax administration should take the differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

Example1: US company sells computer monitors to its Indian subsidiary (ICO) for resale, US company also sells computer monitors to other computer resellers(say CMI) in India on identical terms. In case USCO sells the monitors to CMI for Rs. 10,000/- the CUP price for the computer monitors being sold by USCO to ICO would also be Rs. 10,000/-
Example 2: Suppose in the aforesaid illustration, the terms are different for warranty. The warranty in case of sale of monitors by ICO is handled by ICO. However for sale of monitors by CMI, USCO is responsible for the warranty for 3 months, suppose, USCO and ICO offer extended warranty at a standard rate of Rs. 1000 per annum. In such case, if USCO sells the monitors to CMI for Rs. 10,000/- the arm’s length price for the computer monitors being sold by USCO to ICO would be:

Third party Sale price 10,000/

Less value of 3 months warranty
(Rs. 1000/12X3 = 250)

CUP = 9,750/

Table 6

[Description:- In the above table, Company “A” manufactures Micro Wave Ovens and sells to unrelated distributor company “C” and to its subsidiary Company “B”. Micro Wave ovens sold to “B” and “C” is identical and there is no material differences “A” to “B” and “A” to “C”, then the CUP is the most reliable (best) method.]
The factors can range from similarity of products to market conditions and other contractual terms between parties. Where the products have close similarity and reasonable and accurate adjustments can be made to account for differences the reliability of CUP method is not affected. Some aspects of the transactions that need to be considered for selection of most appropriate method are as under:

a. Similarity of product;
b. Contractual terms:
c. Market conditions
d. Business strategies
e. Use of trademark or brand name:
f. Volume discounts interest free period and exchange rate fluctuations
g. Relative bargaining power and strategies of parties

Where the differences due to comparability factors are material, adjustment may be necessary for determination of arm’s length price provided products are of similar nature and reasonable and accurate adjustments can be made. But in case the differences are not capable of being adjusted then CUP method cannot be considered suitable. In certain situations the subject matter of controlled transactions being goods and services are different from those in uncontrolled transactions available for comparison, and at the same time the functions and other characteristics of such controlled and uncontrolled transactions may be closely similar. In such a case even though certain characteristics and other factors likely to have a bearing on the price charged for the goods and services are relevant to judge comparability, it is the similarity of the underlying goods and services which is fundamental to application of CUP method. Thus, similarity of the subject matter of the transactions shall be established in priority over other characteristics influencing the price of the goods and services.

5.03.8 Adjustment for Differences

Price adjustment on account of product differences may be necessary based on the data gathered from internal and external sources. The price adjustment is made to account for the differences in product quality, quantity, contractual terms, transportation costs, market conditions, risk borne and other factors. The other
factors that may require consideration are foreign currency, risks intangibles associated with sales and alternatives available to buyer and seller. Once these factors are identified adjustments are required to account for differences in product of comparable transaction. Transfer pricing rules in some countries permit adjustments for comparison of uncontrolled transactions prices if differences between third party transactions and related party transactions are ascertainable and capable of being duly accounted for. Such adjustments are permitted under Rule 108 (1) (a) of Indian Income Tax Rules, 1962. The Rule provides that price charged or paid in a comparable uncontrolled transaction should be adjusted to account for differences, if any, between the international transaction and comparable uncontrolled transactions. The differences arise because of variations in contractual terms, differences in volume of sale, differences in timing of the transaction and differences on account of factors such as volume discounts, credit period, etc. for illustration: where a foreign company is selling similar product both to related and unrelated parties on terms and conditions which are identical in all respects except that it extends sixty days credit to related parties as against thirty days credit to unrelated parties, the adjustment would be necessary for difference in payment terms. Such adjustment can be made on the basis of prevailing interest rates.

5.03.9 Merits and limitation of CUP method

CUP method is the most direct of all transfer pricing method, as it involves a comparison of prices. Where reliable comparables are available the results derived by the use of CUP method would be most accurate. Reliability of CUP method depends upon the nature of differences in products and services and possibility of making adjustment to account for differences. Where adjustments are difficult on make on account of difference in quality of goods; geographical markets; levels of market and the type of intangible property involved the use of CUP method is not considered suitable for determination of arm’s length price. Where an internal CUP is not available, lack of publicly available data as regards, comparable prices is the greatest limitation on applicability of the method. CUP method cannot be considered as most appropriate method for determining arm’s length price of the royalty payments; when no data is available of uncontrolled transactions which are similar to or at least closely similar to the transactions of the assessee. The tribunal considered this issue
in case of Cabot India Ltd v Deputy Commissioner of Income Tax ITAT Mumbai. The Tribunal held that the exercise of ascertaining whether the royalty so paid is at arm’s length has to be done independently as per procedure laid down in the rules. The transactions and technology being unique in nature, it is difficult to find out a case involving similar technology. In this case since no data of uncontrolled comparable transactions was available which have similarity or close similarity with the transactions, the CUP method could not be applied for determination of arm’s length price. In this case the assessee is company engaged in the manufacture of carbon black paid royalty to its associate enterprise in the USA at the rates ranging between 3% to 5% respectively on particular products as against royalty rate of 2% on domestic sales. The assessee contention was that increased rate of royalty was favorable with reference to group companies in other countries and if such technology was sourced from outside. Royalty would be charged at higher rates than the current rate. It was argued that there was market increase in the R&D activity of the parent company and quality of product sold and for this reason also the higher rate of royalty was justified. The assessee contended that the rate of royalty was within the range approved by the Government for this industry, the same should be treated at arm’s length price.

CUP examples :( under various situations)

1. ABC Ltd a company incorporated in UK was engaged in business of sale of personal computers. During the year the company sold computers to both related parties and unrelated parties. The transactions were similar except that in respect sales to related party the price included delivery charges, while in case of unrelated party the price included delivery charges was on F.O.B. Factory. CUP method is suitable for supply transactions as differences in product are minor and can be accounted for comparison.

2. UK Company, ABC Ltd., is manufacture of personal computers and supplies them to related and unrelated parties. The Company had taken into consideration value of its trademark in price of controlled transactions, but did not account for it in uncontrolled transactions. Since it was not possible to estimate the impact of trademark on price: the CUP method could not be applied.

3. UK Company, X Ltd., carried out the business of manufacturing machinery components and selling product to related and unrelated parties. The company made minor modifications to the physical properties of machinery to meet the requirements of a controlled sale. However, no such modifications were made in case of uncontrolled sales, CUP method could be applied to determine arm’s length price after making adjustments for differences in physical attributes of the product.

Under Indian Income Tax Act, 1961 the comparable Uncontrolled Price Method (CUP) is explained in Rule 10B(1)(a) of Income Tax Rules 1962\(^\text{193}\) (also in Appendix 10) Rule 10C of the Indian Income Tax Rules 1962 prescribes the methods, wherein the factors that shall be taken into account for considering the most appropriate method\(^\text{194}\).

**5.03.10 CUP in comparison with other methods of Evaluation for Comparability:**

As part of process of selecting the most appropriate transfer pricing method and applying it, the comparability analysis always aims at finding the most reliable comparables. Thus where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated. When performing comparability analysis, due care should be given to:

a. The determination of the available sources of information on external comparables, taking into account their relative reliability

b. The identification of the potential comparables, determining the key characteristics to be met by any uncontrolled transaction in order to be regarded a potential comparable, and

c. The selection of the most appropriate method, determining the relevant financial indicator.

\(^{193}\) Income Tax Rules 1962 Rule 10B(1)(a) reads as follows “comparable uncontrolled price method, by which-(i) The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified: (ii) Such price is adjusted to account for differences, if any, between the international transactions and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market: (iii) The adjusted price arrived at under sub-clause (ii) is taken to be an ALP in respect of the property transferred or services provided in the international transactions:

\(^{194}\) See Supra Note 31 at p. 16
The scope of adjustments has to be widened. All the submissions regarding the disparity between the two transactions should be considered and suitable adjustment is to be made before finalizing the arms length price under the CUP method. Steps to mentioned above has to carried repeatedly until a satisfactory conclusion is reached. The available sources of information for examination may influence the selection of the transfer pricing method. In case tax payer is not able to find information on comparable transactions and make reasonable accurate adjustment, the taxpayer might have to select another transfer pricing method and repeat the process of comparability analysis.

5.03.11 Preference of CUP over TNMM method

OECD Guidelines of 2010\(^{195}\) provides that “traditional transaction methods are regarded as most direct means of establishing the conditions in commercial and financial relations between associated enterprise are at arm’s length. This is because any difference in price of a controlled transaction from a price of a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the associated enterprises, and the arm’s length conditions can be established by directly substituting the price in a comparable uncontrolled transaction for the price of controlled transaction”. As a result when taking into account the traditional transaction method is to be preferred over traditional profit method”. Therefore CUP method would have preference over TNMM where cogent and reliable data is available of comparable prices. But where traditional transaction methods cannot be reliably applied or cannot be applied at all, then TNMM can be applied as a method of last resort.\(^{196}\)

By and large the entire CUP method which is in practice at the International and Indian method can be summarized as under;

Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by the other appropriate methods. All the chosen methods should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. Where difference exist between the controlled and

\(^{195}\) OECD Guidelines 2010 para 2.3

\(^{196}\) Wahi V S “Transfer procedure and documentation an Indian and Global analysis” op.cit., p. 134
uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustment to eliminate the effect on price. The CUP method can be applied when the comparable transaction is identical or nearly similar to the controlled transaction. There should not be such material differences as cannot be reasonable adjusted. The CUP can be applied when an adjustment can be easily made. For example if controlled and uncontrolled sales are similar except for the fact that the controlled sale price is a CIF price and uncontrolled sales are made at the FOB factory. The difference in terms of transportation and insurance are generally definite and reasonable certain adjustment can be made to apply a CUP as comparable. This method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If a difference in the two prices indicates that the pricing is not according to arm’s length principle, the controlled price might need to be substituted by the uncontrolled price. This is the most direct way to apply the arm’s length principle. An uncontrolled transaction is considered to be comparable to the controlled transaction if one of the either two conditions are met “(a) none of the difference (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or (b) reasonably accurate adjustments can be made to eliminate the material effects of such differences” CUP method is the topmost method in the hierarchy of transfer pricing methods. The CUP focuses directly on the price of products sold or transferred. However since the CUP method requires both functional and product comparability, it is not always possible to find similar transactions that could be used as comparable arm’s length transactions. CUP method loses its reliability if a reasonable accurate adjustment cannot be made, due to the non-availability of data from the independent enterprises or the open market/commodity market for the above mentioned items. To conclude the CUP is a very reliable method to apply, from a transfer pricing officer’s perspective, but for getting convinced for the adjustments made or to be made. In today’s world, each enterprise has its own way of doing business. It becomes extremely difficult to arrive at a clear situation for an international transaction and defend the transfer pricing.

197 OECD Guidelines 2010 op.cit., p.63
198 Ibid.
5.04 RESALE PRICE METHOD

The resale price method evaluates arm’s length character of transfer price of a controlled transaction taking into consideration the gross margins realized in comparable uncontrolled transaction. This method is generally used in transactions involving selling and distribution functions wherein reseller/distributor does not add significant value to the product through use of tangible or intangible property.

This method starts with price at which product purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by an appropriate gross margin or resale price margin, which represents the amount out of which a reseller would seek to cover its selling and other expenses and make an appropriate profit. The price arrived is the arm’s length price for the original transfer of property. The resale price margin in controlled sale is compared against the gross margin that reseller earns on the same items in comparable uncontrolled dealings, from an unrelated party: or the gross margin earned by an independent enterprise in comparable uncontrolled dealings. The method can be applied either by using internal mark-up or external mark-up. In internal mark-up the reseller earns the same mark-up in uncontrolled transactions as in controlled transaction. In the external mark-up the gross profit margin of independent enterprise carrying similar functions is compared to a controlled transaction. (pl refer Appendix XII-B & XVRule 10B(b) for RPM)

OECD Guidelines 2010\textsuperscript{199} in case of resale price method an uncontrolled transactions is considered comparable to controlled transaction, if one of the two conditions met:

(a) none of the difference (if any)between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale margin in the open market: or

(b) Reasonable accurate adjustments can be made to eliminate the material effects of such differences.

This method is most useful when applied to marketing operations\textsuperscript{200}. RPM is generally used to test transactions involving distribution function i.e., when the tested

\textsuperscript{199} OECD Guidelines 2010 para 2.23

\textsuperscript{200} ibid.,para 2.16
party purchases products/acquires services from a related party, and resells the same to independent parties. Like CUP method RPM may also be applied by way of internal RPM or an external RPM. This resale price method is worked by backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross markup from the sale price to an unrelated third party, with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing said transaction to other, party transactions. The arm’s length price would be determined by subtracting an appropriate gross margin from the price at which the distributor sold the products received from the manufacturer to third-party retailers.

5.04.1 Methods adopted in the RPM

Under this method the price at which the property purchased from a Associated Enterprise (AE) is resold or the services obtained from an Associated Enterprise is resold or the services obtained from an AE is provided to an unrelated enterprise is taken to be the base price. Such price is reduced by the normal gross profit margin which could be earned by an enterprise in the same or similar comparable uncontrolled transaction. This is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services. The price so arrived at is adjusted to take into account the functional and other differences between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions which could materially affect the amount of gross profit margin in the open market. This adjusted price is taken as the ALP. The same is shown in the Table -7

Table No. 7

| Arm’s length price = Resale price – (Resale price X Resale price Margin) |
| Where Resale Price margin = [(Sales price – purchase price) / Sale price] |
| Resale price margin must be comparable to margins earned by other independent enterprises performing similar functions, bearing similar risks and employing similar assets. |
This method is most suited to measure the value of services that are perfumed by a buyer or reseller who generally acts as a distributor and does not add a significant amount of value to the products they resell. The method is difficult to apply where, before resale the goods are further processed so that their individual identity is lost or changed into another product, and product forms part of semi-finished or finished goods. This method is applicable to marketing operations even with differences in products as long as the functions performed are similar. But it is less useful where goods are subject to further processing and incorporated into other products. The important note in regarding the Resale price method is:

(a) Where applicable resale price is available and resale transaction is made within a reasonable time before or after the controlled sale the method can be applied;

(b) Where distributor or reseller has not added significant amount to the value of property by altering product before resale the method can be considered suitable. However, for this purpose any job in regard to packaging, labeling or minor assembly of goods cannot be regarded as activity in respect of physical alteration to goods sold;

(c) Where controlled taxpayer uses its intangible property to add substantial value to the tangible goods the resale method cannot be applied;

(d) Where time gap between the purchase of goods and its sale by the reseller is small the method can give reliable result;

(e) Where the reseller has the exclusive right to resell goods, the gross margin would be affected by the size of market, existence of substitute goods, and level of activity undertaken by the reseller;

(f) Suitability of this method depends more upon similarity of characteristics having a bearing on the profit margin than the similarity of products. Where uncontrolled and controlled transactions are comparable with regard to other parameters of comparison than the product itself, the resale price method might to be more appropriate than the CUP method, unless in case of CUP it is possible to carry out accurate adjustments to account for differences in the products transferred.
5.04.2 Adjustments for Differences

As per OECD\textsuperscript{201} guidelines the reliability of resale price method may be affected if there are material differences in the ways associated enterprises and independent enterprises carry out their businesses. There are several aspects like business experience, management efficiency and cost structures of the organization, which can affect reliability of gross margin. The adjustment would be needed if there are material differences between the controlled transaction and uncontrolled transactions that affect the gross margin. These adjustments should be made to gross margin earned from the uncontrolled transactions. The adjustments should also take into account the commercial practices, economic principles, or statistical analyses. Under Indian Income Tax Act, 1961 the Transfer pricing method of Resale price method has been defined under Rule 10B(1)(b) of Income Tax Rules 1962\textsuperscript{202} (see in Appendix 10 for detailed and elaborate description of Act and Rules) the examples of calculation of Resale price method and pictorial representation are shown clearly in Table 8 as under:

Resale Price Method Example:

1. A US controlled Tax payer sells property to another member of the group that resells the property in uncontrolled sales. The resale price of product is $100 and general gross margin is 10%. The arm’s length price in the controlled sale would be $90, which is arrived after reducing gross margin from the resale price.

\textsuperscript{201} OECD 1995 paragraph 2.20
\textsuperscript{202} (i) Rule 10B(1)(b) of Income Tax Act 1961 and Rules 1962 reads as under: The price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified:

(ii) 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:

(iii) The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services:

(iv) 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:

(iv) The adjusted price arrived at under sub-clause (iv) is taken to be an ALP in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise:
Description: in the above figure B is the Indian subsidiary of Multinational A which is located overseas. B is distributor of high quality product manufactured by A. A also sells a similar product of lower quality to an independent distributor D in Malaysia. The cost of product purchased from A by B is Rs. 10 per unit. B resells the product to independent party C for Rs. 20. Based on the Functional analysis it was found that functions performed by B are similar to that of D. The gross profit ratio of D was found to be 20% in this example it is noted that there are product (Quality) differences when comparing the controlled and uncontrolled transactions. However the focus of the comparison is on margins, the differences are not material, as they would have been if the basis of comparison were on prices. Furthermore, functions carried out by B and D is similar. Thus the resale price margin of 20% will be used as a basis to determine the arm’s length price of the original purchase by B from A. The Arm’s length product purchased =

\[
= 20 - (20 \times 10\%) \\
= 18 \text{(ALP)}
\]

Example 2. US Company, X sells goods to its associated enterprise Y at price of $600. Y resells the product to unrelated parties at $1000. The total cost of the product to Y is $800 consisting of product purchase price of $600 and other costs incurred to unrelated parties of $200. The appropriate gross margin of comparable transactions is 25%. The arms length price under resale method would be resale price less gross margin less costs incurred to unrelated parties, which would come to

\[
= \$550(\$1000 - \$250(25\% \text{ of} \ 1000\$) - \$200(\text{cost of unrelated parties})
\]

\[
= \$550/-
\]
Example 3: A UK company manufactures a proprietary software CD and sells to its subsidiary company B in India. The Subsidiary company sells the software to uncontrolled parties in India at a price of Rs. 1000/- per CD. The value of intangible rights is reflected in the resale price of CD when sold to uncontrolled parties. On analysis of the functions performed and risks assumed it was noted that there was no difference between the transactions of controlled and uncontrolled parties. In this circumstances the resale price method can be considered as the appropriate method for determining arm’s length price.

5.04.3 Functional and Economic Analysis under Resale method

Under resale method comparability depends on the similarity of functions performed, risks borne and contractual terms. In assessing comparability of the controlled transactions, the uncontrolled sales by the reseller would take precedence over wholly independent transactions. As far as possible the appropriate gross profit margins should be derived from comparable uncontrolled purchases and resale of reseller involved in the controlled sale. Functional comparability is important under this method and the factors that are necessary for consideration are functions performed, contractual terms, risks, economic conditions, and property or services.

The calculation of Resale price method after taking into consideration of various factors like functions performed, contractual risk, Economic conditions and property or services are shown in the various illustration and practical problems of calculation of RPM in the tables mentioned below.
Based on the resale price method the reseller price was Rs. 18 million. After taking into account gross margin of 20% the cost of goods worked out rupees 14.4 million (Rs. 18-3.6=14.4) considering data of comparables companies the arithmetic mean of gross margins worked out as under:

<table>
<thead>
<tr>
<th>Sl No</th>
<th>Company</th>
<th>Gross Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ABC Corp Ltd</td>
<td>32%</td>
</tr>
<tr>
<td>2</td>
<td>DEF Pvt Ltd</td>
<td>28%</td>
</tr>
<tr>
<td>4</td>
<td>LMN business Machines Ltd</td>
<td>35%</td>
</tr>
<tr>
<td>5</td>
<td>GHQ Enterprises</td>
<td>25%</td>
</tr>
<tr>
<td></td>
<td>Arithmetic mean of margins 30%</td>
<td></td>
</tr>
</tbody>
</table>

In the above company considered 30% resale margin for determining the arm’s length price. The cost of goods sold was taken at Rs. 12.6 million after reducing margin of 30% from sale price. As cost of goods sold as per books was Rs. 14.4 millions arm’s length price was arrived after making adjustment of Rs. 1.8 million.

**workings**

Resale price method = Arm’s length price = Resale price—(Resale price X Resale price Margin)

= 18-(18X20%)
= 18-3.6=14.4
=18X30%=12.6(Sale price is 18)
Arithmetic mean of margin n is 30%

Cost of goods sold is 12.6(after reducing margin of 30% from sale price18)
Cost of goods sold as per books is 14.4(sale price-gross margin(18-20% of 18)

**ALP= 12.6(after making adjustment of Rs. 1.8 million from goods sold per book of Rs 14.4 million)**
The concept of Resale price method is a process wherein the product in intra-firm trade would be resold to an independent enterprise without taking the gross margin into account. This means that the arm’s length price is considered to be price of the product after subtracting profit, risk coverage, selling and operating expenses as well as costs for the actual purchase such as customs cost. In this transaction one way to figure out the resale price margin of the reseller in the controlled transaction is by using the resale price margin that the same reseller would use in an uncontrolled transaction. Another way is to use an independent enterprise in a comparable uncontrolled transaction as a reference point. If the resale price margin is related to a brokerage fee, then it should follow the same principles as the CUP method. The difference is that the resale price margin is used instead of the price.

### 5.05 COST PLUS METHOD

The cost plus method (CPM) generally used for the trade of finished goods, is determined by adding an appropriate markup to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with appropriate markup being based on the profits of other companies comparable to the tested party.

*For example, the arm’s length price for a transaction involving the sale of finished clothing to a related distributor would be determined by adding an appropriate markup to the cost of materials, labour, manufacturing, and so on.*

Cost based method calculates transfer price on the cost of the goods or services available as per the cost accounting records of the company. The method is generally accepted by the tax customs authorities since it provides some indications.

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**Table -10**

**Example; 2** Indian Company (ICO) is a distributor of software developed by its parent company in the US. The end customer price (or retail price) of the software is of Rs. 5,000. Assuming comparable independent distributors in India earn margins of 10% the arm’s length transfer price would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final Retail price in India</td>
<td>5,000</td>
</tr>
<tr>
<td>Less: Margin earned by comparable distributors</td>
<td>500</td>
</tr>
<tr>
<td>Transfer Price using RPM</td>
<td>4,500</td>
</tr>
</tbody>
</table>

---

203 OECD 2010 *op.cit.*, pp 65-66
that the transfer price approximates the real cost of item. Cost based approaches are, however, not as transparent as they appear. A company can easily manipulate its cost accounts to alter the magnitude of the transfer price. Companies that adopt the cost-based transfer pricing method have to choose between alternative approaches which are listed below:

a. Actual cost approach
b. Standard cost approach
c. Variable cost approach
d. Marginal cost approach

This method is considered suitable for transactions relating to manufacture of goods or provision of services. It is used when semi-finished goods are sold between related parties in similar situations or in case of joint facility agreements and long term buy and supply arrangements. This method is appropriate where uncontrolled transactions are functionally similar to controlled transactions and therefore, there is no need to benchmark controlled transaction with a transaction that is absolutely identical. For this purpose FAR analysis is critical to identify functionally similar comparable transactions\textsuperscript{204}. Where there is no substantial difference in the functions and risk profiles of the activities undertaken by parties and cost data is available, CPM is most appropriate as compared to TNMM because reliability of data was assured. The important aspect in applying this method is identification of costs that should be marked up and determination of appropriate mark-up. There can be no general rule for determination of costs and therefore, this would depend on the facts and circumstances of transaction under consideration. In the case of \textit{Essar Shipping Ltd vs Dy CIT}\textsuperscript{205} the Tribunal held that under cost plus method, sum of direct and indirect cost along with gross mark-up is taken as arm’s length price in relation to supply of property or provision of services by an enterprise. As per OECD guidelines\textsuperscript{206} in principle historical costs should be attributed to individual units of production though the method may overemphasize historical costs. When some costs

\textsuperscript{204} Aztec Software & Technology Services Ltd v Commissioner of Income Tax (2007) 107 ITD 41. The case has been discussed infra under the chapter practical approach to Transfer pricing mentioned in the case laws

\textsuperscript{205} 5 (1) Mumbai-2012 (12) TMI 670 ITAT Mumbai

\textsuperscript{206} OECD Guidelines, 2010 paragraph 2.49 states that in principle historical costs should be attributed to individual units of production though the method may overemphasize historical costs, when some costs like cost of material, labour, and transport vary over a period.
like costs of material labor and transport vary over a period, in such a case it may be appropriate to average the costs over the period. Averaging also may be appropriate across product groups of over a particular line of production. Similarly averaging can be considered with reference to the cost of fixed assets where the production or processing of different products is carried on simultaneously and volume of activity fluctuates.

Under this method margin earned by the seller is benchmarked against margin earned in comparable uncontrolled transaction and in addition against the margin earned by independent enterprises. Many countries like USA, Korea and Finland apply cost-plus method in order of priority after resale price method. This method will helpful to the contract relating to supply of semi-finished products which are subject to improvements. In India this method is usually applied in case of transactions relating to supply of finished or semi-finished goods and in case of contract manufacturing. In contracts for provision of services, this methods is preferred if data of comparable transactions is available in public domain. Costs considered for this method are the direct and indirect costs of production of goods and provision of services. The trading stock costs are calculated taking into account tax laws of the country concerned. (pl refer Appendix XII-C&XV-c for CPM)

5.05.1 Determining Cost-Plus Mark-up

Cost-plus mark-up is usually the gross margin, which covers general, administrative and selling expenses and allows an appropriate net margin. For this purpose, it is essential to have accounting consistency between controlled and uncontrolled transactions. Where for the purpose of gross profit percentage, full cost of goods sold, including direct and indirect costs is considered then the same basis should be taken into consideration for controlled transactions. The OECD guidelines define cost plus method as “a transfer pricing method using the costs incurred by the supplier of property or services in a controlled transaction. An appropriate cost plus markup is added to this cost, to make an appropriate profit in the light of the functions performed taking into account assets used and risks assumed and the market conditions. What is arrived after adding the cost plus mark up to the above costs may be regarded as an arm’s length price of the original controlled transaction”. The determination of CPM is shown in the example in Table 11
Table 11

Example 1. An Indian subsidiary puts up an assembly plant of a Japanese motorcycle manufacturer in India. The Japanese parent has not supplied capital, automotive knowledge and takes no risk. On the basis of analysis of the financial statements of comparable companies it is determined that similar assembly plants earn 10% on costs. Hence, if the cost of assembling the motorcycle is Rs. 10,000 the transfer price by the cost plus method would be Rs. 10,000 increased by 10% i.e., Rs. 11,000/- when advertising costs are incurred by the Indian subsidiary, and some part of the benefit of this advertising reaches the parent, reimbursement the advertising expenses from the parent cannot be disregarded by the department while computing the arm’s length price.

Under Indian Income Tax Act, 1961 the methodology of Cost Plus method is described in Rule 10B (1) (c)\textsuperscript{207}. (see Appendix XII-C& XV-c for details)

5.05.2 Functional And Economic Analysis: Comparability of transactions under cost-plus method depends upon similarity of functions performed risks borne, contractual terms and nature and type of adjustments made to account for the effects of any such differences. The functions need to be considered for analysis inter alia are manufacturing operations process engineering, assembly research and development, product design material management marketing transportation and management services. Here, the assessee besides functional differences should pay attention to other differences that may impact the reliability of analysis under this method. The other difference can be due to value of trademark, know-how or possessing domain knowledge. The functional and economic analysis can be better understand with the help of following case study illustration:

\textsuperscript{207}. As per Rule 10B(1)(c) of Income tax Rules 1962 reads as follows “cost plus method, by which :-
(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
(ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions is determined;
(iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
(iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause(iii)
(v) the sum so arrived at is taken to be an ALP in relation to the supply of the property or provision of services by the enterprise;
Case Study: a UK based company, ‘X’ Ltd, carries on software development business. The company caters to markets in UK, USA and European countries by undertaking onsite software development and after sales support services. Software development work of ‘X’ Ltd is carried out offsite, by its Indian subsidiary ‘Y’ Ltd. The Indian subsidiary does not undertake similar services for other customers and is remunerated on cost plus 15%. The issue is whether transfer price based on gross mark-up of 15% of cost can be considered as arm’s length price?

Functional analysis was carried out taking into consideration the functions performed, risks assumed and assets used by the parties. ‘X’ Ltd own the intellectual property right of all software developed by the company and undertakes major risks such as market risk and credit risk. The subsidiary company, ‘Y’ Ltd has limited business risks, such as availability of software developers and provision of infrastructure for development of software. All communication costs are accounted for as development costs by ‘Y’ Ltd. ‘Y’ Ltd also extends 70 days credit to ‘X’ Ltd. During the analysis the company made comparison of functions performed, risks assumed and assets utilized of controlled transaction with another company ‘Z’ Ltd which independent enterprise. The comparison revealed following results:

a. ‘Z’ Ltd which is an independent entity undertakes software development for uncontrolled parties at development cost plus 20% gross mark-up.

b. ‘Z’ Ltd does not undertake post sales client service.

c. ‘Z’ Ltd does not account for communication costs as development costs.

d. ‘Z’ Ltd extends 30 days credit to its customers.

e. All other functions, risks and assets of ‘Y’ Ltd and ‘Z’ Ltd are similar.

During analysis adjustments were made considering that independent company was extending reduced credit period to customers, not accounting communication costs as development costs and not undertaking post sales services. Factoring in all these factors the average mark-up of independent companies was worked out at 16.5%.

The determination of the Arm’s length price in the CPM is shown in the Table 12.
Arm’s Length Price Example 1.

‘X’ Ltd had earned 15% gross profit margin on the costs incurred for software development and other services. This was compared with margin earned by other comparable companies which worked out to 16.5% the transaction is therefore, not considered at arm’s length.

Example 1: An Indian company ICO is a wholly owned subsidiary of USCO a US car manufacturer. ICO has an assembly plant. It supplies no capital, automotive knowledge and takes no risk. Based on an analysis of the financial statements of comparable companies, it is determined that similar assembly business earns 20% on costs. Applying this margin to the costs of ICO, one can arrive at the arm’s length transfer price. Assuming that ICO’s cost is Rs. 100, the transfer price under cost plus method would then be Rs. 120.

Example 2: Taxpayer ‘B’ is Indian subsidiary of foreign multinational ‘A’. ‘B’ manufactures electrical components which it exports to A. The electrical components are specially tailored to meet the requirements of ‘A’. All raw materials used in the manufacture of the product are purchased from an independent enterprise ‘C’ at Rs. 200 per unit. The total cost per unit of manufactured product is Rs. 800. ‘B’ then sells the product to ‘A’ at a price of Rs. 1000 per unit. A similar (unassociated) manufacturing company that sells to an independent company is found to have a mark-up of 40%. Since the product is an extensively customized product, there are no product comparables. The mark-up of 40% from the other manufacturing company performing the same functions, bearing similar risks and using similar assets can be used as a basis in arriving at an arm’s length price. Arm’s length price of electrical

<table>
<thead>
<tr>
<th>Table-12</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Arm’s length price</strong> = Costs + (cost x cost plus mark-up)</td>
</tr>
<tr>
<td>Where</td>
</tr>
<tr>
<td>Cost plus mark-up = (Sales price - costs)/cost</td>
</tr>
<tr>
<td>Cost plus mark-up must be comparable to mark-ups earned by</td>
</tr>
<tr>
<td>Independent parties performing comparing functions,</td>
</tr>
<tr>
<td>bearing similar risks and using similar assets.</td>
</tr>
</tbody>
</table>
components sold to ‘A’ by ‘B’ = 800+ (800X40%) =1120  the same is shown in the Table-13

**Table -13**

<table>
<thead>
<tr>
<th>Manufacturer/Supplier B</th>
<th>Distributor/Buyer A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>Rs. 1000</td>
</tr>
<tr>
<td>Purchases</td>
<td>200</td>
</tr>
<tr>
<td>Mfg cost</td>
<td>500</td>
</tr>
<tr>
<td>Overheads</td>
<td>100 800</td>
</tr>
<tr>
<td>GP</td>
<td>200</td>
</tr>
</tbody>
</table>

Cost plus method takes the perspective from the costs incurred by the supplier and then applies cost plus markup to the cost that the supplier would need in order to make an appropriate profit considering the functions performed and the market. The marked up costs can be considered as the arm’s length price of the original controlled transaction. One way to establish the cost markup of the supplier in the controlled transaction is by using the cost markup that the same supplier would use in an uncontrolled transaction. Another way is to use the cost markup from an independent enterprise in a comparable uncontrolled transaction as a reference point.

The same principles concerning product differences for resale price margin can be applied to the cost plus method. By doing so, cost plus method can be used in a broader sense and fewer adjustments need to be made comparing with using the CUP method. Companies can have difference in how effective they are at manufacturing and such differences need to be taking into account when comparing the cost markup price between different companies\(^\text{208}\).

*Sometimes it can be problematic to apply the cost plus method since the level of costs is not always linked to the market price. Another difficulty is that the*

\(^{208}\text{OECD Guidelines 2010 pp 70-71}\)
comparable markup must be compared to a comparable cost basis. If one supplier is using leased business assets while the other is using owned, then the costs might not be comparable with each other if there are no adjustments. Factors that can have an effect on the markup size need to be analyzed in order to be able to do the proper adjustments. That is why it is so important to consider different types of expenses, such as operating and non operating expenses including financing expenditure, associated with functions performed and risks assumed by the parties or transactions being compared. Just like resale method it is important to look at the accounting practices of the enterprise being compared as well as the accounting consistency. The same types of costs need to be used in each case. Generally speaking direct costs and indirect costs of production will be used in the cost plus method. However besides those two costs, the net profit method would count the operating expenses as well.

Variation in the practice among countries may therefore cause problems when using cost plus method\textsuperscript{210} Historical costs should be attributed to individual units of production. However some costs such as materials, labor, manufacturing and transport vary over time, it is therefore most probably appropriate to average the costs over a period of time. The cost plus method is limited to the supplier’s costs which can cause problems if overhead costs are not properly split among the buyer and the supplier in an MNE. The buyer could carry some of the supplier’s costs, thereby diminishing the supplier’s cost base. A follow up problem here is how to properly split the overhead costs should we use turnover, number of employees or something else is the pending question in Cost plus method.

5.06 Other Methods or Transactional profit methods

Complexities of international transactions between associated enterprises make application of traditional transaction methods difficult. When there are constraints in applying the transactions based methods. Recourse is taken to the profit based methods, as these methods are less dependent on transactional similarities. The profit based methods use profits margin for the purpose of determining prices in the arm’s length conditions. The two recognized profit based methods are the profit split method: and the transactional net margin method. Under the profit split method profit

\textsuperscript{209} OECD (2010) pp 72-75
\textsuperscript{210} ibid.
distribution is applied to all associated enterprises, whereas in transactional net margin method it is applied to only one of the enterprises.

The profits based methods specified in the US regulations are the 1. Comparable profits method (CPM) and 2. The profit split method (PSM). The comparable profit method relies on comparable transactions. The profit split are appropriate where both parties to the controlled transaction possess valuable, non-routine intangibles, and no method based on comparable transactions would be reliable. The US regulations prescribe two profit split methods. The first is the comparable profit split, which essentially relies on comparable transactions. The second profits based method is residual profit split which is based on the concept of valuing routine functions, subtracting an appropriate return for these functions and allocating the residual profits. The first step allocates operating income to each relevant entity “to provide a market return for its routine contribution to the relevant business activity” the second step allocates any residual combined operating profits by reference to the relative contributions of intangible property to the business activity that was not taken into the account of the first step.

The arm’s length standard implicitly assumes that each member of a multinational enterprise acts to maximize its own profit. However this model of behavior which is based on theories developed at the beginning of the 20th centuries does not take into account the motivation of multinational corporations to arrange their cross border transactions so as to shift profits to the lowest tax jurisdictions.

The CPM is specified in the OECD guidelines, and is to a large extent similar to the TNMM. While TNMM stresses the profit per transaction the CPM can be used on a more aggregated basis. It can thus be said that the TNMM constitutes a limited part of the CPM. The CP starts with the gross costs incurred. The transactional profit methods described below should only be considered when traditional methods are not applicable. These “last resort” methods take into account profits that arise from particular transactions among associated enterprises which are compared to the profits arising from comparable transactions between independent enterprises.

By and large Indian Income Tax Act, 1961 will not accept methods based on global formulary apportionment on the basis they are bit arbitrary and could not reliably approximate arm’s length conditions. The global formulary apportionment
refers to a method which uses a predetermined and mechanistic formula normally based on a combination of costs, assets payroll and sales; to allocate the global profits of an MNE group associated enterprises in different countries. But an analysis of Indian Case laws it is found that The principle of Global Formulary apportionment application has been accepted the Indian Tribunal in case by name Ericsson Radio System AB(Ericsson) Motorola Inc(Motorola) and Nokia Network OY (Nokia) 211

5.06.1 Profit Split method

Profit split method examines whether allocation of combined profit or loss attributed to a controlled transaction is arm’s length by reference to the relative value of controlled taxpayer contribution to that combined profit or loss. In the case arm’s length price is determined by dividing the consolidated profits of associated enterprises. The combined profit is then split among various enterprises according to an economically valid basis. This method is described in the Indian Income tax Act 1961 and Rule 1962 under Rule 10B(1)(d)

The OECD Guidelines defines PSM as “a transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction or transaction that is appropriate to aggregate and then split

211. Motorola Incvs DCIT 96 TTJ1(2005) supra note 63 p. 40
212. Rule 10B(1)(d) of Income Tax Act 1961 and Rules 1962 reads the section as follows: profit split method which may be applicable mainly in international transactions involving transfer or unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm’s length price of any one transaction, by which-
(i) the combined net profit of the associated enterprise arising from the international transaction in which they are engaged, is determined:
(ii)the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;
(iii)the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause(ii):
(iv)the profit thus apportioned to the assessee is taken into account to arrive at the ALP in relation to the international transaction:
provided that the combined net profit referred to in sub-clause (i) may, in first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transaction by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii) and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction:
those profits between the associated enterprises based upon economically valid basis that approximates the division of profit that would have been anticipated"213

Principles for splitting combined profits and allocating same to one or more controlled transactions are discussed as under:

**5.06.2 Contributions Analysis approach:** Contribution analysis is made for allocating the combined profits from controlled transactions, between associated enterprises, on the basis or relative value of the functions performed by each of the associated enterprises participating in the transactions. This approach ensures that both income and expenses are attributed to the associated enterprises involved in the transaction on a consistent basis. Sometimes it may be difficult to determine the relative value of the contribution made by each of the associated enterprise. In that situation comparison is made about nature and extent of each party’s contribution and a percentage is assigned based upon the relative comparison and external data.

**5.06.3 Residual profit split Analysis:** Residual analysis involves apportionment of combined profit between controlled entities in two steps. First, allocation is made of such profits that would provide basic return to independent enterprises in similar circumstances. At this stage contribution of any unique and valuable assets used by the participants to the transaction is not considered. In the second step the residual profit is divided among the controlled taxpayers based upon the relative value of their contributions of unique and valuable assets.

**Third alternative approach:** The another approach in this method is

1. The combined profits are split in such a way that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction.

2. The profit splitting is done in a manner that it corresponds to the profits arising to independent enterprises in similar transaction.

It may be stated that irrespective of any method followed by taxpayer to allocate profits; the method should be flexible enough to recognize differing contributions made by parties over economic and product life cycles. The basic strength of profit split method is that it can be used in cases where no comparable

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transactions between independent enterprises can be identified. It offers flexibility by
taking into account possible unique facts and circumstances of the associated
enterprises that are not present in independent enterprises. But method has weakness
that market data used for valuing the contribution of each associated enterprise to the
controlled transactions may not exactly be comparable. In practice associated
enterprises and tax authorities’ experiences difficulty in procuring information from
foreign affiliates.

There is also difficulty in computing combined revenue and costs for all
associated enterprises participating in the controlled transactions. This requires
maintenance of books and records on common basis and making adjustments in
accounting practices and currencies. Because of these difficulties this method has not
gained due recognition and not widely used.

5.06.4 Determination of Arm’s length price

1. Determine combined profits of the associated enterprises

2. Evaluate relative contributions of each enterprise towards earning of profits based
   on functions performed, assets employed and risks assumed

3. Split combined profits in proportion to relative economic contribution

4. Profits so apportioned to the assessees is taken into consideration to arrive at an
   arm’s length price of transaction

The determination of Arm’s length price and the methodology under Profit
split method is shown in the Table-14 as under;
Example: ‘A’ is a US intangible holding company that provides patents to a related manufacturing company ‘B’, in India. ‘B’ sells its entire production to a related marketing company ‘C’. there are no significant marketing intangibles(trademarks, etc)

Methodology: In order to determine the arm’s length price for royalty to be paid by ‘B’ in respect patents provided by ‘A’, the following methodology will have to be adopted:

a. ‘A’ set of companies that are comparable to ‘B’ are found.
b. On the basis of the profits of such companies, the optimum profits that should be earned by ‘B’ are determined.
c. Therefore, a set of marketing companies that are comparable to ‘C’ are identified.
d. On the basis of profits of comparable companies, the optimum profits for ‘C’ are determined.
e. The entire actual profits of the group that is, profits of ‘A’, ‘B’ and ‘C’ are then aggregated.
f. From such aggregate profits, the optimum profits attributable to activities of company B and Company ‘C’ as determined in ‘b’ and ‘d’ above are deducted.
g. The balance profits give the value of intangibles held by ‘A’ and would indicate the optimum level of royalty to be paid by ‘B’.

Profit split method is not commonly used in India to determine arm’s length price both by taxpayers and the department. There is hardly any case where tax authorities have preferred this method over other methods. This is because sufficient data is not available to evaluate relative contribution of each of the associated enterprise towards earning of profits. Some countries consider PSM as method of last resort and apply it when other methods do not provide reliable measure of arm’s length price.

In Altman Delta Corporation vs. Commissioner of Internal Revenue\(^{214}\) Altman Delta Corporation a US company, purchased components of Army boots from its wholly owned subsidiary in Puerto Rico. It attached the uppers (top half of a boot) to the soles in its U.S. based facility before selling boots to the Department of Defence. The IRS made adjustments to the firm’s tax returns based on transfer price paid to subsidiary, i.e., ADPR and the failure of ADPR to enter into a cost sharing agreement for product area research. The IRS and ADC have used cost plus method for

\(^{214}\)104 TC 22(1995)
determining the appropriate transfer price. ADC’s expert witness derived a profit for ADPR that resulted in a split of profits that granted slightly more than 50% of total profit to Puerto Rico.

The appropriate level of profit was determined by an analysis of the three other manufacturers of military boots and the use of a gross mark-up. The IRS’s expert instead used the consumer footwear and leather industry and looked at gross margins. The military boot manufacturing industry was highly profitable for the three years in question because the department of defense restricted bidders to a select number of firms. The general US footwear industry saw declining sales during the same period.

The court held that IRS determined transfer price was arbitrary and unreasonable. It found that the firm considered by the IRS was not comparable to a military boot manufacture as they had to design products (instead of manufacturing to specification). Besides several firms had distribution and retail operations and did not have manufacturing contracts. The court did not completely accept ADC’s transfer price but instead relied on 50/50 total profit split. The transfer price, once determined was used to find Puerto Rico’s share of the cost sharing agreement.

In Elli Lilly & Co Subsidiaries v Commissioner of Internal Revenue\(^\text{215}\) Elli Lilly and Company a US company transferred patents for a drug to its subsidiary in Puerto Rico. The Puerto Rico subsidiary manufactured the drug for selling back to US Company. The US Company then marketed and sold drug to third parties in United States. The taxpayer attempted both CUP and resale price method but these were not allowed for lack of both CUP and Resale price method but for lack of adjustments. Potential CUPs were not allowed because they involved sales in unprotected markets and appropriate adjustments were not made in other cases. The resale price method was disallowed because the potential comparable involved the taxpayer’s own internal transactions.

The Court held that the Puerto Rico’s manufacturing subsidiary was entitled to location savings. Transfer prices were inferred by a profit split method, whereby all of the profits derived from manufacturing and marketing intangibles were split on a 55/45 basis between the Puerto Rico subsidiary and the parent.

\(^{215}\) 84 TC 996 (1985)USTC
Profit split method can be understood by going through the example in the Table -15

Example 1. ‘X’ ‘Y’ and ‘Z’ are companies located in different countries. Company ‘X’ designs and manufactures the major components of a high quality electrical product which it sells to its subsidiary ‘Y’. From these components, ‘Y’ further develops and manufactures them into the final product which it exports to ‘Z’ an independent distributor.

```
Table-15

X
Manufactures major components

Y
Manufactures final Product

Z
Distributor
```

“*The trading accounts of ‘X’ and ‘Y’ are as follows*”

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>100</td>
<td>300</td>
</tr>
<tr>
<td>Purchases</td>
<td>15</td>
<td>100</td>
</tr>
<tr>
<td>Manufacturing cost</td>
<td>20</td>
<td>35</td>
</tr>
<tr>
<td>Gross profit</td>
<td>65</td>
<td>165</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>Net profit</td>
<td>30</td>
<td>140</td>
</tr>
</tbody>
</table>

[Description: The final product in the transaction happens to be a unique product for which there are no comparable. However, research indicates that there are several companies that carry out similar functions to that of ‘X’ and ‘Y’ involving similar net mark-ups for these independent companies involved in transactions similar to ‘X’ and ‘Y’ is 30% and 20% respectively.]

Application of Methodology

The above example, the CUP method cannot be used due to uniqueness of final product.( for the sake of simplicity, assume that ) there is insufficient data and information to apply the cost plus method, while the resale price method is
inappropriate as the product has undergone substantial transformation at ‘Y’. The profit split method is adopted using the residual approach.]

**Residual analysis of group profit with the above example (X&Y) is shown in the Table -16**

### Table 16

<table>
<thead>
<tr>
<th>Calculation of Total profit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Sales</strong></td>
</tr>
<tr>
<td>Total Sales</td>
</tr>
<tr>
<td>Cost of goods sold(X)</td>
</tr>
<tr>
<td>Cost of goods sold(Y)-excluding purchases</td>
</tr>
<tr>
<td>Gross profit</td>
</tr>
<tr>
<td>R&amp;D</td>
</tr>
<tr>
<td>Other operating expenses</td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
</tr>
</tbody>
</table>

**Description of Calculation of the Basic Return**

The mark-ups derived from external data will be used to calculate

Basic returns to X and Y are as under

1. Basic Return to X= 30%(COGS+other operating expenses)
   
   = 30%(35+15)
   
   =15

2. The calculation of basic return to Y has to take into account that the COGS for the comparable independent companies have included the purchase price for the semi-finished product. Since this is the transfer price for Y, the basic return for Y will be a function of the Transfer price i.e.,

   = 20% of [(COGS-purchase price)+other operating expenses+ALP]

   = 20%(35+10+TP)

   = 9+0.2TP

The profit split method includes the comparative and residual profit split methods. This profit split method will be applied when the business in the examined
transaction are too integrated to allow for separate evaluation, and so the ultimate profit derived from the endeavor is split based on the level of contribution itself, this will often determined by some measurable factor such as employee compensation, payment of administration expenses. The residual profit split method initially focuses on the company in a controlled transaction which performs the most routine functions, for example toll manufacturing or distributing services. The residual profit split method seeks to set the appropriate arm’s length remuneration for such least-complex entity, whereby the remaining profit is allocated to the other company of the controlled transaction.

5.07 Transactional net margin method (TNMM)

The Transactional Net Margin is a method for computing arm’s length price of a transaction where the object of comparison is net profit margin relative to an appropriate base. Under this method the net profit margin of transaction is calculated with reference to an appropriate base say costs, sales or assets. This method is applied when available data of comparable transactions is unreliable or inadequate to apply comparable uncontrolled price, resale price or cost plus methods. Under this method the net margin realized by a taxpayer from a controlled transaction is compared with net margin earned in comparable uncontrolled transactions. The comparison of the net margins is done either at entity level with appropriate adjustments or at transactional level depending upon the availability and reliability of the comparable data.

The OECD Guidelines defines TNMM as “a Transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction or transaction that it is appropriate to aggregate” This method is used often as it compares profits and not prices. Only in cases where the profits of an enterprise are attributable to similar transactions and when an enterprise does not have any other transaction activity which is not similar and which distorts the profits, the net margin method may be used. While determining the operational cost under this method, it is submitted that foreign exchange fluctuations cannot be excluded and must be taken into account. Income tax refunds obtained by the assessee cannot be included in his profits, but donations made

216. Kanga & Palkhivala’s “the law and practice of Income Tax” op. cit., pp 1752-1753
by assessee can be included because refund received by the assessee is not income but the donations made is reasonable expenditure.

In the case the assessee is a large profit making company its profits cannot be compared with another one that is much smaller, running of loss and rendering services which are vaguely similar but not identical. This method is described in Rule 10B (1) (e)\textsuperscript{217} of Income Tax Act, 1961 and Rules 1962. (for detailed statute of the TNMM method Appendix XV Rule 10B to 10E of Indian Income Tax Rules 1962)

5.07.1 Comparability of Transaction: The comparability of the transactions is judged taking into account the specific characteristics of the property or services, functions performed, contractual terms or conditions prevailing in the market. The comparison of the profit margin can be on a single transaction or in relation to some aggregation of dealings between associated enterprises. This method operates on a basis similar to cost-plus and resale price methods as the net profit margin is calculated on some appropriate base, like costs, sales, and assets. Therefore, the net margin from the controlled transaction is established by reference to net margin earned by the taxpayer from comparable uncontrolled transactions or from net margin that would be earned in comparable transactions made by independent enterprise. A functional analysis is also carried out to determine the comparability of transactions and make necessary adjustments. Comparability analysis must be perfumed to select and apply TNMM so that method is not less reliable than any other method. In practice the level of information available on the factors which have effect on external comparable transactions is limited and therefore determining reliable estimate of arm’s length outcome requires flexibility and good judgment. A high degree of

\textsuperscript{217} Rule 10B(1)(e) reads as follows:

(i) the net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected are assets employed or to be employed by the enterprise or having regard to any other relevant base:

(ii) the net profit margin realized by the enterprise or by unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base:

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, 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 net profit margin in the open market:

(iv) the net profit margin realized by the enterprise and referred to in sub-clause(i) is established to be the same as the net profit margin referred to in sub-clause(iii)

(v) the net profit margin thus established is then taken into account to arrive at an ALP in relation to the international transaction
similarity is therefore required in number of aspects of the associated enterprise and the independent enterprise to make transactions comparable. TNMM should not be applied unless profit level indicators are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable transactions are of the independent enterprise, the difference between the associated enterprise and independent enterprise that has material effect on the net profit indicator are adequately taken into account. The TNMM considers net margins earned by an enterprise at broad functional level taking into consideration nature or class of international transaction. The comparison is made between net margins derived from the operations of unrelated parties with the similar operations carried out by associated enterprises.

Functional analysis of the associated enterprise as well as the independent enterprise will have to be applied to determine comparability. Since net margins (unlike gross margins or prices) tend to be significantly influenced by various factors other than products and functions (e.g. competitive position, varying cost structures, differences in cost of capital etc) it is stressed that usage of TNMM be confined to cases where functions have a high degree of similarity, so as to eliminate the effects of these other factors.

5.07.2 Functional analysis. The Functional analysis regarding nature of transaction is made by analyzing functions performed by the entities, keeping in view the assets used and risks assumed by parties. The analysis helps in determining the economic value added by each enterprise involved in transaction and deciding whether transactions are comparable or whether any adjustments are required to be made. The net margin thus established after considering the adjustments is taken into account to arrive at arm’s length price of the international transactions. This method is preferred for the following reasons:

1. Identification of comparable uncontrolled transaction;

2. Computing net profit margin or operating profit margin of controlled transaction and comparing it with the net margin of comparable uncontrolled transactions:

3. Conducting functional analysis to determine, whether transactions are comparable and adjustments are needed to obtain reliable results:
4. Adjusting net profit margins for material differences, which can affect net margin in open market: and

5. Determine arm’s length price based on net profit margin so established

When compares to other methods TNMM is widely preferred for determination of arm’s length price because net margins are more tolerant to some functional differences in transactions than gross margins. This method is widely preferred for the reason:

1. The net margin are least affected by factors that affect price;
2. Transactional differences do not have much role;
3. The difference in functions performed assets used or risks assumed may be reflected in variations in operating expenses and hence net margin can be used for comparison;
4. This method is useful when one of the party to the transaction has complex functions and reliable information is not easily available;
5. Indian database are always depended on this TNMM as the comparable data at net marginal level is easily available as compared to external data for comparable uncontrolled price, resale price or cost plus methods.

5.07.3 Limitations

- Reliable and accurate determination of arm’s length margins is difficult when net margin is influenced by some factors that either do not have an effect, or have a lesser effect, on price or gross margins.
- The taxpayers may not always have information in respect of uncontrolled transactions when controlled transaction is entered into with associated enterprise.
- They may not have access to information on the profits attributable to uncontrolled transactions.

5.07.4 Arm’s length price Determination: TNMM is commonly used to compute arm’s length price as it is difficult to apply traditional transaction method where object of comparison is price because of lack of publicly available data of comparable uncontrolled transactions. In many cases comparable uncontrolled price method may not be found appropriate if the product supplied is unique and instances
of comparable transactions are not available. This method is sometimes used if the other transaction based methods like resale price or cost plus cannot be used. The arm’s length price is computed as follows:

1. Net margin realized by enterprise from international transaction is computed in relation costs incurred or sales turnover or assets employed or to be employed by the enterprise or considering some other relevant base. When figures of net profit margin are not available operating profits may be considered for the purpose of comparison;

2. Net margin or operating profits earned by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base. The base for comparison can be cost, sales or assets. It is noticed that cost is invariably taken as base as it provides more reliable measure for comparison;

3. Adjustments are made to the net margin realized in uncontrolled transactions to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the net profit margin in open market conditions;

4. Net margin or operating profits realized by the enterprise is established to be the same as the net margin arrived after making due adjustments for material differences in transactions;

5. Finally the net profit margin so established is taken into account to arrive at an arm’s length price in relation to the international transaction;

*Examples of TNMM*

1. M/s ABC Ltd., an Indian company entered into a contract for purchase of ERP software from its parent company in Belgium. The value of the transaction in Indian Rupees was Rs. 650,000/-. It entered into another contract with parent company valuing Rs. 10,500,000/- for providing technical services for which it received commission on sales. After making functional analysis the Indian enterprise it came to the conclusion that transactional methods like CUP, Resale, and Cost Plus could not be used mainly because of lack of data of comparable prices or gross margins. The company therefore chooses TNMM as the most appropriate method for
determining arm’s length price. After making the study, the arithmetic mean of the net profit margins of comparable companies was compared by the taxpayer with its net operating profit margin for the accounting year under consideration. The net profit margin so determined was rightly taken as the basis for computing arm’s length price of the transactions.

**Example II.** M/s ABC Ltd an Indian company is distributor of electronic goods manufactured by its US parent company. The electronic goods are sold to uncontrolled retailer in India. There are three other uncontrolled companies that buy similar products from US manufacturer and sell to independent retailers. The functional analysis shows that three independent distributors perform exactly the same functions as the Indian distributor. *As comparable companies are unlisted companies the only information available is in regard to sales and net profits.* M/s ABC therefore decides to apply TNMM method in determining arm’s length price in regard to its transactions with US parent company. The company decides to use return on sales as its profit level indicator. The variable data shows that net profit margin on sales of three comparable companies is 3%, 4% and 5% the arithmetic mean of the net profit of three companies work out to 4% which taken as the basis for comparing arm’s length price. Assuming that general and administrative cost of the Indian distributor is 2.5% and selling cost of 6% of sales, the company must earn gross margin of 12.5% of sales to earn net margin of 4%. Suppose the net selling price of the product is 800$ the company must earn 100$ to have desired net profit margin. The arm’s length price would therefore be $700 per unit payable by the Indian distributor to the US parent company.

**Example III:** ‘X’ is an Indian Subsidiary of ‘Y’ located overseas. ‘Y’ manufactures computers, which it sells to ‘X’ and other associated distributors in different countries. The computers distributed by ‘X’ bear company ‘Y’s trademark. ‘X’ also provides technical support to all its customers. The example can be shown in the pictorial representation for better understanding in Table -17 as under
Table-17

<table>
<thead>
<tr>
<th>Trading Account for ‘X’</th>
<th>1,00,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>90,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>10,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>15,000</td>
</tr>
<tr>
<td>Net loss</td>
<td>(5000)</td>
</tr>
<tr>
<td>Margin</td>
<td>5%</td>
</tr>
</tbody>
</table>

Assume that the CUP method is not applied as no reliable adjustments can be made to account for differences with similar products in the market; and the resale price method is not used as no comparable measurement of gross margin can be found due to differences in accounting practices amongst independent distributors. The TNMM is adopted on the basis of net profit return on sales. It was found that the net profit margin to sales earned in a comparable transaction by an independent enterprise is 5%

Adjustments on ‘X’ will be as follows

Net profit of X= 1,00,000X 5%=5,000

Adjusted cost of goods sold= 1,00,000-15,000-5,000=80,000/-

5.07.5 Comparability Standard under TNMM

Under TNMM net profit margin of an enterprise is not affected as much by difference in product as in case of traditional transaction methods like CUP, resale price and Cost plus method. When two enterprises perform similar functions, the net margins may still not be comparable, particularly when such enterprises carry on their functions in different types of markets. OECD guidelines\(^{218}\) are relevant in respect of comparability standard mentioned in the guidance notes of OECD 2010.

\(^{218}\) OECD Guidelines para 2.70, 2.71 and 2.74 of OECD Guidelines, 2010 para 2.70 reads as under “the use of net profit indicators can potentially introduce a greater element of volatility into the determination of transfer prices for two reasons. First net profit indicators can be influenced by some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variant of operating expenses across enterprises. Second net profit indicators can be influenced by some of the same factors, such as competitive positions, that can influence price and gross margins, but the effect of these factors may not be as readily
An OECD guideline prefers and recommends the method of multiple year data which will take care of abnormalities that affects the profit abilities. Multiple year data smoothens out results and eliminates short run issues. *In India there is no provision for considering multiple year data for different years till 2013. Consequent to which results are averaged within a year though it may not give best results where industry is highly affected by product life cycle.* The Union Budget for 2014-2015 containing the tax proposal of NDA government has been presented by the Finance minister to the parliament which proposed to include various concepts in Transfer pricing like “range concept”, use of multiple year data for comparability analysis by taxpayers has also been referred in the speech. Accordingly the Indian TP regulations prescribes taxpayer to maintain contemporaneous information on comparables as part of their TP documentation to demonstrate that the pricing policy in relation transactions with associated enterprises complies with arm’s length principle.

The Comparable information is crucial element for defending transfer price in India. Over the years, taxpayers have suffered adjustments due to the flip-flop and political miasma surrounding the issue whether to allow use of prior year uncontrolled comparable data relied upon by the taxpayers or otherwise. Indian courts have consistently failed to appreciate that multiple year data ought to be used for determination of ALP, in absence of contemporaneous data.

Para 2.71 reads as under: “Net profit indicators may be directly affected by such forces operating in the industry as follows: threat of new entrants, competitive position, management efficiency and individual strategies, threat of substitute products, varying cast structures (as reflected for example, In the age of plant and equipment) difference in cost of capital (e.g. whether the business is in a start-up phase or is mature) Each of these factors in turn can be influenced by numerous other elements, For example the level of threat of new entrants will be determined by such elements as products differentiation, capital requirements, and government subsidies and regulations. Some of these elements also may impact the application of the traditional transaction methods.”

Para 2.74 reads as follows: “The transactional net margin method may afford a ‘practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for differences of the type referred to above. The transactional net margin method should not be used unless the net margins are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, Where the comparable uncontrolled transactions are those of an independent enterprise, the differences between the associated enterprises and the independent enterprises that have a material effect on the net margin being used are adequately taken into account. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus where differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply to the transactional net margin method without making adjustments for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the transactional net margin method.”
5.07.6 **Entity level comparison under TNMM** Indian income tax act 1961 and Income tax rules 1962 as per which Rule 10B (1) (e) under TNMM do not provide for entity level comparison. It means the net margin realized in relation to common base namely cost, turnover, or assets needs to be computed for each international transaction. In practice the entity level comparison is made because of lack of information in public domain at transactional level. This issue was observed by the Income Tax Appellate tribunal Ahmadabad in a case *Dishman Pharmaceuticals & Chemicals Ltd vs. Deputy Commissioner of Income Tax*\(^{219}\) here the assessee had carried out comparability at entity level and not at transaction level while applying TNM method. The assessee had applied TNMM for computation of arm’s length price for its sales to subsidiaries. The net margin as a whole was compared with net margins earned by organic chemical manufacturing companies. The assessee had aggregated all the transaction and did not give any reason for such aggregation and computed net margin on its entire sale. *Tribunal held that TNMM method requires computation of net margin on each transaction or aggregation of similar transactions. Selection of this method and computation of net profit on entire sales of company becomes irrelevant when internal CUP data was available for certain transactions. Here, the tribunal referred the case of *UCB India Pvt Ltd v ACIT Mumbai*\(^{220}\) where it was observed that TNMM refers only net profit margin realized by an international transaction or class of such transactions. The class of transition of an enterprise may be evaluated on aggregated basis in cases when only similar transactions are undertaken i.e., all the transactions are of the same type and of similar variety. Tribunal in this held the selection of comparables at the entity level in this case was not proper as data of internal CUP was available.

In *UCB India Pvt Ltd Vs ACIT*\(^{221}\) UCB India is wholly owned subsidiary of UCB S.A.Belgium. The company carried out business of manufacture and distribution of pharmaceutical products. It manufactures active ingredients required for manufacturing of drug formulations. Some other ingredients are imported by it from its parent company, or are procured locally from third parties. The Indian subsidiary imported two active ingredients namely “piracetam” and “mesna” from its parent company in Belgium which are used for finished drug formulations. (FDFs). The

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\(^{219}\) Laws (GJH)-2012-7-392  
\(^{220}\) (2009)124 TTJ (Mum) 239  
\(^{221}\) Ibid.
The assessee applied TNMM to determine arm’s length price of raw material purchased from its parent company. The Transfer pricing Officer (TPO) rejected TNM method and adopted CUP method for comparability purposes. He proposed adjustments of Rs. 2,09,75,500 for AY 2002-2003 and Rs. 3,00,18,803 for AY 2003-04. The Tribunal observed that the assessee was manufacturing many other drugs other than ‘piracetam’ and ‘nutropil’. It therefore, considered aggregate net operating profit margins of multiple activities of the organizational as a whole. Net profit margins reflect manufacturing of different types of drugs, patented, licensed etc. as well as trading activity in the case of the assessee. Therefore assessee should establish functional comparison and demonstrate that these companies had similar ration of manufacturing activity as compared to trading activity. *An object of comparison was operational profit such comparison could not be said to be as per law. It is held that the international transaction or an aggregate of similar international transactions, have to be evaluated, on a standalone basis and then compared with similar analysis undertaken on independent transactions.* Comparing operating profit of the assessee company as a whole with the overall operating profits of certain other companies, without any adjustments, would not satisfy the requirements of evaluating an international transaction under TNMM for purpose of computing arm’s length price. The Tribunal also held CUP is most appropriate method. The additions made by the assessing officer on this issue were unsustainable. In the captioned case even billing period, amount of credit is significant effect on the price. *Pricing of a product is a very subjective exercise and its true value, as received by the receiver can differ from that received by others in the market place. Therefore CUP requires a high degree of comparability along with quality of the product or service the comparable chosen by the revenue are some Chinese companies, the details of which were not disclosed to the assessee. The assessee’s repeated queries on the standards, processes, purity barrels etc, followed by those Chinese companies and many other details, data information and parameters, could not be replied to or supplied by the revenue hence the adoption of CUP method could not be accepted as most appropriate method and deleted the additions on this account. As for as TNMM selected by the assessee, it held that analysis made was not in accordance with law as assessee had compared overall operating profit of one entity, with the overall operating margins of the company. The Tribunal set aside the assessment order.*
It has been observed that the facts and circumstances of the said case do not fit either to CUP method or TNMM method. As these methods require the special characteristics to fulfill the degree of comparability. CUP requires high degree of comparability along with quality of the product or service contractual terms level of market geographical market intangible property associated with sale and also scientific basis is required like purity potency and characteristics. In the TNMM the analysis made by the assessee is not in accordance with the established law of comparing overall operating profit of one entity, with the overall operating margins of the company. Now the assessee is under dilemma to choose which method to follow. Hence it is very difficult to judge the methods under these circumstances the assessee has to file fresh transfer pricing study report.

As per study on most preferred method for determination of Arm’s length price has revealed that the transactional net margin method (TNMM) was the most appropriate method for determination of Arm’s length price. The status of the most preferred method in F. Y 2006-2007 is represented in the following table.

<table>
<thead>
<tr>
<th>Methods/type of preferred</th>
<th>The percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>TNMM are [referred</td>
<td>72%</td>
</tr>
<tr>
<td>CUP</td>
<td>195</td>
</tr>
<tr>
<td>CPM</td>
<td>06%</td>
</tr>
<tr>
<td>RPM</td>
<td>03%</td>
</tr>
<tr>
<td>PSM</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

(Source: Director General of Income Tax (Transfer pricing New Delhi Income Tax Department 2012) the percentage of taxpayers who are opting for TNMM are 72%. The lease is Profit split method. The data can be represented in the Bar Graph as under

**Status of Most preferred Methods in India during the period of F.Y 2006-2007**
TNT India Pvt Ltd v Assistant Commissioner of Income Tax Circle 12(3) Bangalore

TNT India Pvt Ltd was wholly owned subsidiary of one GD express Worldwide NV, Netherlands which was ultimately controlled by one TPG NV Netherlands. The operating subsidiaries of TPG were engaged in providing express, logistic and main services and it included door to door delivery documents, parcels and freight services. The assessee, TNT India was a courier company operating within Indian territory and its functions included picking up consignment is overseas bound, the assessee entrusts the work to its overseas AE to ship the consignment to the country of destinations and to deliver it to the addressee. Similarly when a group company operating in a different country collects a consignment within India it entrusts the assessee to transport the consignment within India and to deliver it to the addressee. The costs incurred by group as a whole are pooled up and allocated to the company which has actually incurred and the expenses and that company is reimbursed to that extent. The International transaction between the assessee and TPG group pertained to the cost recharges from and to the respective enterprises for inbound and outbound shipments, including hub charges, data processing charges, line haul charges, delivery charges etc., Certain costs such as delivery commercial line haul charges were reimbursed without a mark-up. Certain other costs carried a mark-up of 3 to 5% and the model for reimbursement and mark-up was the same for all group companies. The assessee in its TP analysis adopted TNM method and took operating profit/sale as the profit level indicator. It identified four courier companies as comparables and since arithmetical mean of their PLI was 3% as compared to the assessee’s PLI of 1% and the difference was within the 5% margin, the transactions were claimed to be at arm’s length. The TPO agreed with the selection of TNMM, he found that the assessee had not used contemporaneous data and added one more comparable, compared the ratios for the year 2001-2002 and found that profit before the depreciation, interest and tax was 2.5% in the case of tax payer while industry average is 8.75% and profit before interest and tax was 1.1% in the case of tax payer while industry average is 6.7%. thus the profit earned by the tax payer was much below the industry average rate and determined the ALP of the transaction at Rs. 39,40,07,000/-

\[222\]. ITA No 1442(BNG)2008 decided on March 2011 (2011-TII-ITAT-BANG-TP)
Before the CIT (A) the assessee argued that the AO had to record reasons before making a reference to the TPO and even after an order was passed by the TPO, the AO should have applied his mind before adopting the arm’s length price determined by the TPO which was not done in the case. It also argued that the assessee had entered into a Transportation Recharge Agreement which covered all the members of the TNT entities operating worldwide and as per this agreement, each member received the revenue earned on consignments within its exports and is charged at costs by the group entities for all costs of handling. With respect to use of multiple year data it was contended that the same was approved by the OECD Guidelines and as such should be allowed. The CIT(A) held that there was no illegality or arbitrariness in the order of the Assessing Officer in making a reference to the TPO in adopting the computation of ALP determined by the TPO: that what was extraordinary was the complete absence of any mention of a methodology or a formula or a basis for allocating costs for purposes of reimbursement: that the payments made by the group companies to other companies was in consideration of services rendered and it cannot be considered to fall under the category of reimbursement even if such payments were equivalent to cost.

When the case went to the Tribunal it held the AO is not required to demonstrate the existence of the circumstances set out in clauses (a) to (d) of Sec. 92C(3) before referring the case of the assessee to the TPO for determining the ALP under Sec 92CA (1) of the Act. The tribunal analyzed that the fluctuation caused by business/economic/product life cycle would not affect the pricing pattern of the services of the relevant financial year. In the absence of any cogent and reasonable reasons given by the assessee for justification of use of multiple year data, except placing reliance upon the OECD guidelines and also the proviso to Rule 10B(4) of the Income Tax Act 1961 there is no reason to interfere with the order of CIT(A) The OECD guidelines are not of binding nature and even the provisions to Rule 10B(4) only provides that any subsequent year data cannot be considered. Tribunal held that for arriving at the net margin of operating income, only operating income and operating expenses for the relevant business activity of the assessee are to be taken into consideration. The counsel for the assessee contended that the other incomes, such as dividend income, profit on sale of assets; donations was wrongly included in the operating incomes of other comparables companies. Tribunal in the
circumstances of case remanded the issue to AO/TPO and directed to rework out the operating margins of the comparables of the assessee and make adjustments accordingly. It held that ALP shall be arrived at after giving standard deduction of 5% of the arithmetic mean.

5.07.7. Whether TNMM is method of last resort

Indian Regulations do not prescribe for priority of methods approach and taxpayer has freedom to choose any one of the prescribed methods if it gives reliable measure of arm’s length result. However, for documentation study the taxpayer must keep the record of various methods considered and reasons for rejecting methods other than the one selected. The OECD old guidelines gave preference to the traditional transaction methods over transactional profit methods. This distinction has been done away with OECD revised Guidelines, 2010 as per which all the methods have been placed at par for selection of most appropriate method.

5.07.8 Choice of other method

As per section 92C of Indian Income Tax Act, 1961 which emphasis on the arm’s length price in relation to an international transaction or specified domestic transaction is to be determined by any for the six methods prescribed therein. In the original provision cited in the legislature provided five methods: three transactional price methods and two profit methods and left the sixth method to be prescribed by the Board” if as and when considered necessary”. In exercise of this power the Central Board of Direct Taxes vide notification no 18/2012(F. No. 142/5/2012/TPL ) dated 23.05.2012 has amended income Tax Rules, 1962 and introduced a new rule 10AB which permits the assessee to compute arm’s length price as per the other method prescribed in the Rule.

Also the OECD has made a real effort to recognize

\[223\] Para 2.4 of the Revised Guidelines provide that there can be situations where transactional profit methods are found to be more appropriate than traditional transaction methods. For example cases where each of the parties makes valuable and unique contributions in relation to the controlled transactions, or where the parties engage in highly integrated activities, profit split method may be more appropriate than a one-sided method. Similarly when there is no or limited available reliable gross margin information on third parties, transactional profit method may be more appropriate. As such TNMM is not method of last resort and choice of particular method would depend upon the peculiar facts of case and availability of information.

\[224\] Income Tax Rules 1962 of new rule 10AB reads as under: “ the other method for determination of arm’s length price in relation to international transaction shall be 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 circumstances, considering all the relevant facts.”.
the concept of ‘other method’ or ‘residuary method’ as per which some other countries considered it as more appropriate in the facts and circumstances of the case. The countries which permit the use of other method are China, Germany, Honking, Israel, Hungary, Kenya Luxembourg, Portugal and USA. As a result taxpayer have leverages in regard to choice of methods and can resort to this method if traditional transaction methods or profit methods fails to apply in circumstances of the case and arm’s length result can be justified by applying the other method.

The use of the other method is possible if it takes into the account the price of same or similar uncontrolled transactions. The comparable price that can be applied by the taxpayer is one which is otherwise not permissible under the comparable uncontrolled price (CUP) method. Sometimes there are practical difficulties to use CUP when controlled transaction relates to intro-group service or payment for royalty. This is because comparables are not easily available for such transactions especially when no similar transactions take place in uncontrolled conditions. The use of other method is satisfied only if taxpayer justifies the arm’s length result by applying valuation methods commonly used for determination of price or a transaction or proposed transaction. For this purpose data relating to price negotiation or third party quotations, tender documents, quotations of commodity exchanges and valuation reports can be considered. For comparison of transactions various comparability factors prescribed in rules have to be satisfied.

5.08 Transfer pricing of intangibles

The concept of Intangibles plays crucial role in Transfer pricing methodologies. Intangible means property which has value based on intellectual content rather than physical attributes of the asset. Intangible asset does not exist in physical form but is recognized because of owner possessing rights over domain knowledge and contents. Generally intangible is created as a result of research and development work and is capable of being exploited commercially. These intangibles include assets, such as patent, invention, formulae, process design, pattern, know-how trademark, license or similar other property. Market prices of products are affected by type of intangible property owned by an enterprise. When a product having well-known trade is transferred it would command a higher price as compared to another

225 OECD Guidelines 2010 paragraph 2.9
product having similar attributes but not associated with a known trademark. The ownership criteria are important consideration for transfer pricing of intangible asset. The owner of the asset may be legal owner or economic owner. Where the intangible asset like a patent or trademark is legally protected the legal ownership test would apply for transferability of the right in property. Generally it is difficult to determine arm’s length price of intangible assets as suitable data of comparable transactions gets further complicated where intangible is transferred along with tangible property or provision of services. The intangibles are three types.

1. Manufacturing intangible:- There are created as a result of research & development work. or some domain knowledge. They consists of assets such as patent, design invention, formulae know-how used for production of goods and provision of services.

2. Marketing intangible :- these are property that helps in commercial exploitation of product or service such as trademarks and trade names. They consists of unique names, symbols, or pictures that have an important promotional value for the product concerned.

3. Hybrid intangible:-they are intangibles which have attributes both of manufacturing and marketing intangible, for example the success of an enterprise, if dependent upon reputation enjoyed by the enterprise over a period of time and not on any particular brand it would be a case of hybrid intangible.

5.08.1 Special consideration for Intangible property

The transfer of intangibles between associated parties may be carried out in the following manner;

1. Outright sale or transfer either for consideration, or by way of gift, or capital contribution

2. In form of lease of license where royalty is paid to the owner

Due to the nature of intangible, which are essentially unique products, special consideration are needed. These include

1. Determining whether the intangible does exist. Marketing activities comprising of market research, product promotion etc need not necessarily result in the creation of a business asset; likewise not all R&D expenditures lead to the
production of trade intangible. In such instances, these expenses may be treated as current expenses. The treatment of these activities will have a bearing on the functional analysis carried out to establish comparability

2. The terms of agreement between the transferor and transferee has to be evaluated for the reason whether the transfer is an outright sale or a licensing agreement for royalties to be paid if so the basis of payment, also find out whether the product transferred out has included compensation for use of intangible property, and if so whether other payments such as royalties or payment for provision for technology

5.08.2  **Comparability analysis and Arm’s length application for Intangibles**

The Arm’s length principle, the concept of comparability and the basis of choosing the most appropriate method/methods all apply to intangibles just as they do to tangible property. A comparability analysis must take into account;

1. The expected benefits from the intangible property in both the controlled and uncontrolled transactions

2. In the case of patent, the nature and duration of the patent, the patent laws in the relevant countries, the value(final product) that is attributable to the patent

3. In the case of marketing intangible(e.g. trademark) the value added by the trademark taking into account consumer acceptability, geographical significance, market share sales volumes etc,

4. It is acknowledged that finding comparable uncontrolled transaction will be a difficult task. For this reason, the profit split method is often used. In determining comparability or relative value of contributions of each party, the amount, the nature, the incidence of the costs incurred in developing or maintaining the intangible property must be examined.

Section 92 of Income Tax Act, 1961, deals with income arising from international transaction shall be computed having regard to arm’s length price. Transfer pricing provisions apply to an international transaction including transfer of intangible property. As per OECD\textsuperscript{226} the common arrangement to transfer intangible asset may be an outright sale of the intangible or a royalty under a licensing

\textsuperscript{226} Para 6.16 and 6.17 of OECD Revised Guidelines 2010
arrangement. The compensation for use of intangible property can be included in the price of goods or by way of additional payments for licence charge or royalty. A controlled transactions involving transfer of intangibles is regarded at arm’s length if the results of the transactions are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. In practical it is difficult to apply arm’s length principle in case of intangible property due to difficulty in precisely defining such asset and assigning value for taxation purpose. Intangible property such as a patent, design, and invention can hardly be compared to similar property as there are not comparable transactions between unrelated parties. The traditional transaction methods like CUP, Resale price and Cost plus, cannot be applied in such a case because there is no proper object of comparison. Even transaction net margin method may not work as there are no comparable margins available.

5.08.3 **Special considerations for Intra-Group Services**

In most MNEs a wide range of services such as R&D administrative, technical aid, financial or other commercial services are provided for intragroup use. Some services e.g. technical air, often incorporate the provision of know-how. The costs of such services, initially borne by the parent or other service companies within the MNE, will through some intra-group arrangement eventually be recovered from other associated companies. The main issues with regard to intra-group services are;

1. Whether intra-group services have been provided;

2. If so, whether the intra-group charge for the services are at arm’s length prices

The following factors should serve as a guide in determining whether services have been rendered;

1. Whether the activity of one group member has provided the other group member with economic or commercial value and whether an independent enterprise in comparable circumstances be willing to pay or perform in-house for itself such activities

2. In general, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party
3. Incidental benefits to an associated enterprise arising out of activities or services meant for other group members of the MNE should not be taken as intra-group services for that particular associated enterprise.

4. A functional analysis of the various group members may be performed to establish the relationship between the relevant services and the members activities and performance.

5.08.4 Comparative analysis of Arm’s length principles in connection with USA, UK, Australia and India (also see appendix – III&IV of this thesis for detailed picture of documents required in connection with transfer pricing methodologies)

Table-19

<table>
<thead>
<tr>
<th>Sl No</th>
<th>Name of the Country</th>
<th>METHODOLOGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AUSTRALIA</td>
<td>Transfer pricing methods in Australia are consistent with OECD Guidelines. The traditional transactional methods used are comparable uncontrolled price method; resale price method; and cost plus method. The profit based methods that can be applied are profit split method; and transaction net margin method.</td>
</tr>
<tr>
<td>2</td>
<td>INDIA</td>
<td>Arm’s length price of transactions between associated enterprises can be determined as per Comparable Uncontrolled Price method (CUP); Resale price method; Cost plus method; profit split method and Transactional net margin method. The law empowers Board to prescribe such other method as may be considered necessary. In may 2012 the Board notified the 6th method as ‘other method’ for determination of arm’s length price.</td>
</tr>
<tr>
<td>3</td>
<td>United Kingdom</td>
<td>The arm’s length price is determined as per comparable uncontrolled price method; resale price method; cost plus method; profit split method; transactional net margin method and other methods.</td>
</tr>
<tr>
<td>4</td>
<td>United States of America</td>
<td>Transfer price methods recognized for allocation of income and expenses of controlled transactions are comparable uncontrolled price method; resale price method; cost plus method; comparable profits method; profit split method and other unspecified methods. Under US services regulations the methods recognized for determining price of services related transactions are comparable uncontrolled services price method; gross services margin method; cost of services plus method; and services cost method.</td>
</tr>
</tbody>
</table>
5.08.5 Comparison with other jurisdictions/countries Inter-country comparison (also see Appendix-8 which gives comparative analysis of inter-country comparison methods and use of multiple year data)

Table-20

<table>
<thead>
<tr>
<th>Particulars</th>
<th>INDIA</th>
<th>AUSTRALIA</th>
<th>UK</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>METHODS</td>
<td>CUP, RPM, CPM, PSM and TNMM</td>
<td>CUP, RPM, CPM, PSM and TNMM</td>
<td>CUP, RPM, CPM (PSM &amp; TNMM can be employed as a support or cross check over other transactional methods)</td>
<td>CUP, Resale Price, Cost Plus, Comparable Profit Split, Residual Profit Split, TNMM and CPM</td>
</tr>
<tr>
<td>Priority</td>
<td>No priority</td>
<td>Traditional methods over profit based methods as per the OECD Guidelines</td>
<td>Transaction based preferred over profit based</td>
<td>No priority Best method rule applies</td>
</tr>
<tr>
<td>Use of multiple year data</td>
<td>Permitted only exceptionally</td>
<td>Permitted</td>
<td>------</td>
<td>permitted</td>
</tr>
</tbody>
</table>

5.09 Formulary System Vs Arms length principle – a comparative analysis

The concept of Arms Length Principle is widely practiced since last 30 years or more. The OECD Transfer pricing Guidelines (TPG) in the first chapter itself observed as under:

“The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question. For example to avoid double taxation there would have to be common agreement to adopt the approach in the first instance, followed by agreement on the measurement of the global tax base of an MNE group, on the use of a common accounting system, on the factors that should be used to apportion the tax base among different jurisdictions (including non member countries) and on how to measure and weight those factors.
agreement would be time-consuming and extremely difficult. It is far from clear that countries would be willing to agree to a universal formula.”

“Even if some countries were willing to accept the global formulary apportionment, there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximize that country’s own revenue. In addition tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula (e.g. sales capital) to low tax countries. There could be tax avoidance to the extent that the components of the relevant formula can be manipulated e.g., by entering into unnecessary financial transactions, by the deliberate location of mobile assets, by requiring that particular companies within on MNE group maintain inventory levels in excess of what normally would be encountered in an uncontrolled company of that type, and so on”

Arm’s length method is internationally recognized to be the acceptable method of transfer pricing for MNEs(Multi-national Enterprises). The arm’s length principle states “transactions between associated enterprises should not be distorted by the special relationship that exists between parties, as such the arm’s length principle is neutral”. That Neutrality is then built upon by local jurisdictions and pricing is mandated by local law. Most countries follow their own transfer pricing treaties and legislation, which follows the OECD guidelines227 that allows for transparency. What is most disturbing is the fact that despite the transparency established by the OECD guidelines, it still leaves room for dishonesty and uncanny opportunity to fudge numbers within organizations.

Whatever its theoretical merits, it is clear that the introduction of global formulary apportionment presents numerous practical difficulties, political228 and otherwise. The Introduction of the global formulary apportionment (Unitary taxation)

227. Transfer pricing legislation-A suggested Approach
www.oecd.org/ctp/transferpricing/45765682.pdf accessed on 07.03.2015
228. UNCTAD 2010 reports op cit., p14 political difficulties of adopting formulary apportionment at the international level are particularly evident in the European Union, where a policy for the introduction of a common consolidated tax base was first proposed in 2001. Despite various revisions, the member states have not been able to reach an agreement (as on October 2012) visited at http://ec.europa.eu/taxation-customs/taxation/company-tax/common-tax-base/index-en.htm. On 02.03.2015 at 2 A.M
would require agreement by a significant proportion of countries regarding the appropriate formula, the definition of a “unitary business” (for which profits should be aggregated) the basis on which profits are calculated (i.e., common accounting standards). In addition to these challenges international tax obligations arising from tax treaties that includes functional currency to be used, that include the arm’s length principle may pose a further barrier to implementation. If agreement on these issues could be reached, implementation into domestic law would then be required by a critical mass of countries, adoption by only a small number of countries would result in increased incidence of economic double taxation or less than singular taxation for multinational enterprise groups with operations in the countries adopted formulary apportionment, because profits taxed under global formulary apportionment in one country would likely be subject to the arm’s length principle in other jurisdictions and vice versa. If this is not solved the economic double taxation imposes an additional transaction cost on multinational enterprise groups, hindering international trade and foreign investment. Additionally multinational enterprise groups that must apply two different approaches will face increased compliance costs. The apportionment finds origin in the intrinsic difficulty of attributing income in a satisfactory was by source. The theoretical background relies on the assumption that certain elements of a business fairly reflect the measure of the tax to be attributed to particular state. The concept of formulary apportionment and Arm’s length principle were dealt in detail in chapter VII of this thesis.

5.10 The potential for double taxation if conflicting approaches are adopted

If conflicting approaches to transfer pricing are adopted by two countries this will result in the inconsistent allocation of a multinational enterprise group’s profits between the group members for tax purposes which will give rise to either economic double taxation or less than single taxation.

For example, if Country ‘A’ adopts the arm’s length principle and Country ‘B’ adopts global formulary apportionment the sum of the profits allocated to Company ‘A’ and Company ‘B’ may exceed their actual aggregate profit, giving rise to economic double taxation (Table-20) alternatively, if Country ‘A’ adopts the Global Formulary apportionment and Country B adopts Arm’s length Principle the

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sum of the profits allocated to Company ‘A’ and Company ‘B’ may be less than their actual aggregate profit, giving rise to less than single taxation. (shown in table-21)

**Economic double taxation arising from conflicting approaches**

**Table-21**

Here company A adopts Arm’s length principle and Company B adopts global Formulary apportionment

If country “A” adopts Arm’s length principle and Country ‘B’ adopts Global Formulary apportionment the sum of the profits allocated to company A and company B may exceed their actual aggregate profit, giving rise to economic double taxation.

**Less than single taxation arising from conflicting approaches Table-22**
Table-22

<table>
<thead>
<tr>
<th>Country A</th>
<th>Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>Company B</td>
</tr>
<tr>
<td>GFA</td>
<td>ALP</td>
</tr>
</tbody>
</table>

Aggregate Profit = 200

Less than single taxation

| 100             | 50              |

Sum of allocated profits = 150

[ Description:- Here Country ‘A’ adopts Global Formulary Apportionment and Country ‘B’ adopts Arm’s length principle the sum of the profits allocated to companyA and company ‘B’ may be less than their actual aggregated profit, giving rise to less than single taxation:]

Due to various practical difficulties associated with the adoption of global formulary apportionment- in particular the potential for significant incidence of double taxation or less than single taxation and the lack of consensus as to the detail—formulary apportionment has not yet been adopted at the international level for tax purposes. But the countries like USA Canada, Switzerland has adopted the system of Formulary apportionment while deciding the issues of Transfer pricing application and methodologies. Though in reality the adoption of global formulary apportionment is not considered a realistic alternative at present, but due to the complex problem of Arm’s length principle particularly in intangible properties concerned, the system of Globular Formulary apportionment stood in the foot lines of Arm’s length principle. It is noteworthy to mention that the Arm’s length principle is a neutral concept that does not, in theory favor developed or developing countries. In practice however, it is often argued that developing countries are at a disadvantage vis-a-vis developed countries due to the practical difficulties they face in
implementing the arm’s length principle. Though many critics argue that the implementation of Globular apportionment formula results in double taxation and additional compliance costs imposed. In principle the globular Formulary apportionment finds a way for alternative to Arm’s length principle at the moderate level.

5.11 Solutions to transfer pricing

CCCTB solutions to transfer pricing as applied in EU its relevance to India

During the year 2001 the European Commission embraced a strategy for the future company tax policy in the European Union dealing with “the fundamental concept of a common company taxation system in the form of a consolidated corporate tax base for the internal market” according to the Commission

The enterprises should, in long term, be able to reach a consolidated corporate tax base with cross-border loss, relief under a single set of tax rules for their EU activities. There are four methods

1. Home State Taxation (HST)
2. Common consolidated Base Taxation (CCBT)
3. European Union Corporate Income Tax(EUCIT)
4. Compulsory Harmonized Tax Base(CHTB)

Upon verification it is found that each system has its own benefits and drawbacks, some options may be more politically feasible than others, while others may be more economically or administratively practical than others. But each of the method provides a way for EU companies to calculate their EU group income on an EU wide basis; each method uses a formula to allocate

1. Home State Taxation (HST): here the option can be exercised by the companies for computing their income for their operations located in various Member States participating in the home state tax system.I according to the company income tax rules of the members state where their headquarters are located (the ‘home’state) here the theory is applied is mutual recognition- as per which the member state hosting investment from another member state participating in the system would agree to accept the tax rules of the home state for determining the tax base in the host member state. A different set of tax rules would apply in
the EU depending on the tax base in each home state. Home state tax authorities would administer their particular home state tax system. Profits would be allocated to member states participating in the system using a common formula, where they would be taxed local rates. Profits would be determined under current national systems for non-participating Member states.

2. **Common consolidated Base Taxation; (CCCTB)** EU companies would have the option of calculating their income, for their operations located in various Member States according to a new common EU tax base. This EU tax base would operate in parallel with existing national rules. The Same set of tax rules would apply throughout the EU. The Member state where the company was headquartered would administer the common EU tax base. Profits would be allocated to all member states using a common formula, where they would be taxed at local rates.

3. **European Union Company Income Tax (EUCIT)** according to which it is system which would operate in parallel with existing national rules it would be optional for companies in one form this system could create a federal EU tax and single tax authority could administer the tax, with revenues funding EU institutions and activities or the member states could administer the EU company income tax.

4. **Compulsory Harmonized Tax Base (CHTB)** a single EU tax base and tax code would replace national company tax systems. This EU tax system would apply to all enterprises in all member States and the national company tax systems would disappear. The Member states could administer the tax so there would be no need to create an EU level tax.

In general these proposed methods appeared as a possible solution to the problem regarding the arm length framework. Although the CCCTB was as “the only systematic way to address underlying tax obstacles” existing in companies that have associated enterprises in several countries within the internal market. A new framework was made in 2004, 2008 and 2011 wherein legislative proposal for optional directive to create a new system of working principle to solve the problem of Transfer pricing issues. The main goal of CCCTB is the creation of economic

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efficiency within the internal market with all the benefits arising from it due to the reduction of the effective tax rate, the compliance of only one set of rules and the elimination of transfer pricing and double taxation within the CCCTB. The new CCCTB is the object of a Proposal from the European Commission dated from March 2011 for a council directive, which was released with the main purpose of tackling some major fiscal impediments to growth in the Single market.

5.11.1 The New CCCTB proposed scheme

On a prima facie analysis this European apportionment mechanism is an ambitious project, by using a complex sharing formula yet flexible when it comes to its application. Although this is not a Commission innovation since it takes, in its attempt to reach the above mentioned goals, full use of the experience, non-European tax legislations providing for formulary apportionment such as Canada and the United States. In this sense one of the most sensitive topics the European Commission had to address in the development of the CCCTB was the uniform apportionment formula. One advice that can be taken from the US experience is that more uniformity is recommended for a European system of FA. The US formulary apportionment system suffers, for example from different tax base definitions, differences in the scope of enterprises, subject to formulary apportionment and as shown, differences in the formulas themselves all of which result in higher administrative and compliance costs, proneness to tax unnecessary complex system. Thus in many experts opinion, the uniformity of the apportionment formula has a greater priority than a sound economic justification.

The factors chosen in apportionment formula are of high importance since they determine the distribution of the tax base across jurisdictions. In the case of more labour intensive country, like India it will receive a larger share of profits from the labor factor. Therefore the apportionment mechanism may be regarded as a key factor, highly influential to both states and multinationals.

Walter Hellerstein described Formulary Apportionment as “by taking this Formulary apportionment (FA) as a method for determining the corporate tax base of a single company or group of associated companies attributable to a Member State by reference to a formula that assigns a proportionate share of company or associated companies, corporate tax base to the state by reference to a factor or factors that
reflect (or are deemed to reflect) the underlying income-producing activities within
the state.

The main priority purpose of the CCTB is the elimination of the tax obstacles
to corporate cross-border activity, in a single market with a view of enhancing the
effectiveness of the internal market. In fact, in the light of the afore mentioned some
ECJ rulings increase pressures for tax harmonization at the EU level and strengthened
the determination of certain EU Member States to go ahead with proposals from
Common Consolidated Corporate Tax Base. The European parliament and
Economic and Social Committee framed the article called the principle of
proportionality and subsidiary according to which direct tax legislation shall vest the
legal form of a Directive, primarily with cross border issues and it requires a common
approach at the Union level, namely approval by unanimity.

5.12 Comparative analysis of the Arm’s length principle, Formulary apportionment and CCCTB approach of Europe Table-23

<table>
<thead>
<tr>
<th>Arm’s length principle</th>
<th>Formulary apportionment</th>
<th>CCCTB approach of Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Arm’s length standard is enshrined in both the OECD and UN Model Tax Conventions as well as the thousand of bilateral double taxation treaties</td>
<td>1. The system of formulary apportionment view that the formulary apportionment reflects economic reality and multinational companies operates as an economic unit, and not as if they were unrelated to their foreign subsidiaries. By this way they argue that the multinational group should be viewed on a consolidated basis to reflect the business realities of relationships of associated enterprises\textsuperscript{231}</td>
<td>1. This was adopted in the European commission on March 2011 the aim of the CCCTB(Consolidated Corporate Tax Base) is far reaching harmonization of the corporate tax base and full consolidation of group profits across the EU while leaving tax rates at the discretion of Member states. Under this method consolidated profit would be shared according to a formula which takes into account the location of multinational enterprise’s assets, workforce and sales.</td>
</tr>
<tr>
<td>2. Article 9 of the OECD Model Tax Convention has an authoritative statement of the Arm’s length</td>
<td>2. Global formulary apportionment lowers the costs of compliance for taxpayers here a consolidated group need</td>
<td>2. The commission treats this as a comprehensive solution which would do away with all these tax obstacles like cross-</td>
</tr>
</tbody>
</table>

\textsuperscript{231} U.S. Transfer Pricing Formulary Apportionment vsArms length standard no 110 Kluwer Publication (2012) p28
principle found in paragraph 1 of OECD convention to keep one set of accounts for tax purpose under this system  

3. Arm’s length principle follows the approach of the treating the members of the MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the member of a MNE group as if they were independent entities, attention is focused on the nature of transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions, which is referred to as a “comparability analysis” is at the heart of the application of the arm’s length principle.

3. Formulary apportionment is a preferable method because it is simpler and easier to apply. The followers of the formulary apportionment view that the Arm’s length principle by contrast is unworkable and unenforceable.

- The scientific work which has been focused sharing mechanism, concretely on formulary apportionment could eliminate the problem with transfer pricing within multinational corporations.
- Gorden and Wilson (1986) examined how corporate taxation of MNE’s using formula apportionment affects the incentives faced by individual firms and individual states.
- McLure has proved that when formula consists of the factors as property of the company, payroll and sales, corporate income tax transforms into a tax on property, payroll and sales.

Based on these points of reference there is a strong basis for this method versus the arm’s length method.

<table>
<thead>
<tr>
<th>3. This method of CCCTB has three basic features</th>
<th>1.harmonization of tax base</th>
<th>2.consolidation</th>
<th>3.formulary apportionment</th>
</tr>
</thead>
</table>

If CCCTB were adopted a European company would only have to deal with one set of rules in order to calculate its profits for tax purposes instead of having to comply with up to 27 different set of rules as at current.

Article 10 of CCCTB “the tax base shall be calculated as revenues less exempt revenues, deductible expenses and other deductible items” Interest is deductible a loss carry back is not possible. Credit method applies only to passive income of the CCCTB-D

The important feature is optionality. A European company would be free to decide to calculate its profits for tax purposes according to the rules of the CCCTB or to continue to apply national tax rules. If CCCTB is chosen it is binding for 5 years and prolonged for 3 years. The territorial scope of consolidation is limited to the European Union only.

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232. Ibid., p. 29
233. OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administration July 2010
234. Musgrave P “International tax base division and the multinational corporation public finance” 27,934-413 (1972) the view were cited in the Common Consolidated Corporate Tax Base, sharing the base under formulary apportionment (2011)
4. In order to calculate or test the arm’s length nature of prices or profits, use is made of transfer pricing methods or methodologies. Transfer pricing methods are ways of calculating the profit margin of transactions or an entire enterprise or of calculating a transfer price that qualifies as being at arm’s length. The application of transfer pricing methods is required to assure that transactions between associated enterprise conform to the arm’s length standard. Further transfer pricing methods are not determinate of themselves. If an associated enterprise reports an arm’s length amount of income without the explicit use of one of the transfer pricing methods recognized in the OECD Transfer pricing Guidelines, this does not mean that its pricing is automatically not at arm’s length and there may be no reason to make adjustments.

4. The critics of formulary apportionment several reasons for rejecting the system:
1. Formulary apportionment is inflexible because it is based on a predetermined formula that disregards individual facts and circumstances. It operates in an arbitrary fashion.
2. It is doubtful that formulary apportionment would protect against double taxation while ensuring single taxation. For formulary apportionment to succeed internationally, significant international coordination and consensus would be necessary. All countries would have to agree on predetermined formula and on all the factors contained within. This would be extremely difficult due to the economic and political differences between countries.

4. CCCTB formula consists of three equally weighted factors “labour, assets, and sales” (article 86(1) of the CCCTB-D) the formula would share the consolidated group profit among the entities belonging to the multinational enterprises in question. CCCTB would serve a double function it would allocate a share of the consolidated profit to each group entity and at the same time allocate taxing rights to the member states involved. The allocation of profits according to the arm’s length standard is a cornerstone of the international tax system. If such an important and in spite of all its undeniable flaws running system is to be abandoned, there should be a clear evidence of the superiority of the new system.

5. The arm’s length principle has different treatment applied to it based on the industry the organization does business with. While deciding an arm’s length price, sometimes it may be very hard to establish a price simply because there are no comparable products within that country or industry to

5. In the system of formulary apportionment it would be necessary to agree to a common definition of the taxable base to be apportioned under the formula. This presents an extraordinarily difficult obstacle to overcome. Every country has unique accounting and tax rules which regulate definitions of income as well as deductions for social


establish a price simply because there are no comparable products within that country or industry to establish baseline. In such situation a best guess price is name, which is allowed if a reasonable estimate is made. That also allows for wriggle room if it has a sufficient arm’s length price. In this arm’s length principle affiliated businesses should set transfer price at levels that would have prevailed had the transaction occurred between unrelated parties. In such situation a best guess price is name, which is allowed if a reasonable estimate is made. That also allows for wriggle room if it has a sufficient arm’s length price. In this arm’s length principle affiliated businesses should set transfer price at levels that would have prevailed had the transaction occurred between unrelated parties. In such situation a best guess price is name, which is allowed if a reasonable estimate is made. That also allows for wriggle room if it has a sufficient arm’s length price. In this arm’s length principle affiliated businesses should set transfer price at levels that would have prevailed had the transaction occurred between unrelated parties.

<table>
<thead>
<tr>
<th>5.13 Whether Arm’s length principle suitable for Developing countries like India- A critique</th>
</tr>
</thead>
<tbody>
<tr>
<td>The aim of the tax legislation that adopts the arm’s length principle is to ensure that the conditions of transactions between associated parties are not distorted by their relationship so as to adversely impact the determination of the relevant taxable base.</td>
</tr>
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<tbody>
<tr>
<td>6. Arm’s length only takes into consideration the individual subsidiaries and how they contribute to the overall product. Then each individual number is figured into the overall operational costs.</td>
<td>6. Formulary apportionment is a simplification of evaluation it not only takes the totality of the profitability of the MNE into account and is not dependent on the country or what jurisdiction it is located in.</td>
</tr>
<tr>
<td>7. Several countries like US, Canada and Switzerland are following this formulary apportionment for the fiscal reason and documentation.</td>
<td></td>
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</table>

In this regard the arm’s length principle is a neutral concept that does not, in theory, favor developed or developing countries. In practice however, it is often argued that developing countries are at a disadvantage vis-a-vis developed countries due to the practical difficulties they face in implementing the arm’s length principle. Such practical difficulties generally arise due to a combination of capacity and informational constraints. These difficulties are very minute in developing countries, which are faced by many developed countries. The advantages and disadvantages of the arm’s length principle for transfer pricing are as under in the table-23

Table-24

<table>
<thead>
<tr>
<th>Advantages of Arm’s length principle</th>
<th>Disadvantages of Arm’s length principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provides the tax administration with the necessary legal basis to protect the tax base.</td>
<td>Relies heavily on (comparable) information, which may not exist or be readily available.</td>
</tr>
<tr>
<td>Reduces instances of economic double taxation</td>
<td>Can result in the imposition of a significant compliance burden on taxpayers</td>
</tr>
<tr>
<td>Creates a level playing field between associated and independent enterprises, foreign and domestic enterprises, and countries (by, for example, limiting the potential for enterprises to obtain a competitive advantage by limiting their tax liabilities through transfer mispricing)</td>
<td>Can result in the imposition of a significant compliance burden on taxpayers</td>
</tr>
<tr>
<td>Satisfies obligations a country may have under international law (as a result of tax treaties in force that contain an Article 9 of OECD)</td>
<td>Requires discretion by the tax administration, which if not properly controlled may provide opportunities for corruption or result in the imposition of unnecessary compliance costs</td>
</tr>
<tr>
<td>Reduces uncertainty for taxpayers and tax administrations, both of which can draw on an extensive body of internationally accepted principles and practices</td>
<td>May require adjustments to uncontrolled transactions to improve comparability, which can be complex and somewhat arbitrary.</td>
</tr>
<tr>
<td>Puts a country in a position to influence future developments in international transfer pricing and protects the interest of resident taxpayers in discussion with other tax authorities</td>
<td>Use of one-sided methods may not take into account network profits and economies of scale. Requires significant capacity building within the tax authority. Multinational enterprises</td>
</tr>
</tbody>
</table>

241. Ibid., p 17. the concept is adopted for customs purposes in the World Trade Organization Valuation Agreement whereby considerations is required of whether the transaction value of a transaction between related parties has been influenced by the relationship between the parties.
may enter into transactions that independent enterprises do not.

- Reduces (global) compliance costs for multinational enterprise groups, which need comply with only one approach to transfer pricing, making it more likely that they do so on a global or regional basis
- Many developing countries have a limited number of tax treaties in force (which provide the legal basis for ensuring relief from economic double taxation

These practical difficulties arise due to a combination of various factors like informational constraints, capacity to enter agreement etc., these difficulties arise both in developing as well as developed countries. Most of the countries developed and developing are facing practical difficulties associated with the implementation of the arm’s length principle. The legislation of the country in India has to be tailored to specific circumstances; sufficient resources are made available to develop the capacity of the tax authorities; and enforcement activities target the sectors and transactions that pose the greatest risks. If there is any failure it is due to the lack of practical issues. Also the comparative analysis of the Arm’s length principle Formulary Apportionment point out that no one system gives the full solution any problem. Particularly the problem of Transfer pricing which is crucial over the years it is difficult in the present set of society which method alone will solve the problem of Transfer pricing. Indian TP regulations prescribes taxpayer to maintain contemporaneous information on comparables as part of their TP documentation to demonstrate that pricing policy in relation to transactions with associated enterprises complies with the arm’s length principle. The Finance Bill 2014-15 has made specific amendments like introduction of “Range Concept” for determination of ALP(Arm’s length price). Sn 92CC of Indian Income Tax Act 1961 introduces the ‘roll back mechanism’ in the present advance pricing agreement (APA) scheme. Hitherto India was not accepting the use of any range(viz inter-quartile range) which has been accepted by the developed economies across the globe. The present section 92CC provide that APA shall be valid and remain effective for five years including the year for which the APA is sought. The FB 2014 provide the provision of “roll back” provisions which refers to the applicability of the methodology of determination of ALP, or the ALP, to be applied to the international transactions which had already been entered into in a period prior to the period covered under an APA. This concept
of roll back gives rise to quick disposal of pending chronic litigation faced by many taxpayers at present which may result in easy disposal. But this has yet to be confirmed in the coming days. Also the section 92B(2) of the Indian Income Tax 1961 provide an amendment by FB 2014 wherein “in respect of transactions entered into by an Indian enterprise with an unrelated person, if there exists a prior agreement between the associated enterprise of the Indian enterprise with such unrelated person which by any means has influence over the pricing of the aforesaid transaction, then such transactions shall be deemed to be an international transactions entered into between two associated enterprises. This needs analyses from the arm’s length perspective.

5.14 Conclusions

Transfer pricing issues were not given due importance in developing countries. But in view of growing involvement of multinational enterprises in the economies of these countries, it was necessary that they formulate rules and regulations concerning transfer pricing. Moreover, the countries which are new to the international transfer pricing arena are increasingly at risk until they adopt regulations that concern pricing of transactions of goods and services transferred between related parties. It is very much necessary for the developing countries to make development in view of growing transfer pricing regime. The developing countries have to adopt the regulations that concern pricing of transactions of goods and services transferred between related parties. The motivation for transfer pricing manipulation, as some MNEs engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through non arm’s length transfer pricing in order to reduce the aggregate tax burden of the MNE. However, while reduction of taxes may be a motive influencing the MNE in setting transfer prices for intro-group transactions, it is not the only factor that determines the transfer pricing policies and practices. Ongoing through various facets it is found that the Guidelines further provide that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. A functional analysis of the associated enterprise and, in the later case, the independent enterprise is required to
determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. For tangible property the guidelines provide that where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm’s length principle. Consequently in such cases the CUP method is preferable over all other methods\textsuperscript{242}. A CUP method is likely to be used where there is a comparable service provided between independent enterprises in the recipient’s market, or by the associated enterprise providing the services to an independent enterprise in comparable circumstances. For example, this might be the case where accounting auditing legal or computer services are being provided. A cost plus method would likely to be appropriate in the absence of a CUP where the nature of the activities involved, assets used, and risks assumed are comparable to those undertaken by independent enterprises\textsuperscript{243}.

Upon going through the practices of the above subject it is evident that an alternative to the arm’s length principle might be a Global Formulary Apportionment Method which would allocate the global profits of the MNE group amongst the associated enterprises on the basis of a multi-factor weighted formula (using factors such as property, payroll and sales for example, or such other factors as may be defined when adopting the formula). A Formulary apportionment approach is currently used by some states of the USA, Cantons of Switzerland and provinces of Canada. Also, the Brazilian transfer pricing rules set out a maximum ceiling on the expenses that may be deducted for tax purposes in respect of imports and lay down a minimum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil. The European Union is also considering a Formulary approach, at the option of taxpayers, to harmonize its corporate taxes under the Common Consolidated corporate Tax Base (CCCTB) initiative. For intangible property establishing arm’s length pricing in the case of a sale or license of intangible property, it is possible to use the CUP method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises. If the aforesaid enterprise sub-licenses the property to third

\textsuperscript{242} Para 2.7 of the OECD Guidelines
\textsuperscript{243} Para 7.31
parties, it may also be possible to use some form of resale price method to analyze the terms of the controlled transaction.

The main purpose of the Arm’s length standard is to ensure related party transactions are transferred at prices competitive to open market and to prevent tax evasion. The corporation studies have been challenged as to whether the comparable transactions used as proof abide with the arm’s length standard. Each corporation’s unique operations and transactions have tested the Tax court’s interpretation of arm’s length regulations. A comparable transactions element in the arm’s length standards is flawed and ambiguous because large multinational companies survive on unique related business transactions that have no comparables. A determinable arm’s length standard transfer price, when no unrelated comparable transaction is present, is impossible. Because of this imperfection, uncertainty surrounds the arm’s length standard.

On examination of various case studies it is observed the arm’s length standard was the main disagreement in all of the court’s decisions. Even the appeal court was confused between whether the arm’s length standard should apply in all cases or if all costs should be shared in a cost sharing agreement or not. The cardinal principle which can never be lost sight of is, that the objective is to determine an ‘a price which is applied in a transaction between persons other than associated enterprises, in uncontrolled conditions’. Hence, whatever be the method being applied, the effort /objective / attempt should be to arrive at a price which independent enterprises in uncontrolled conditions would have transacted at.

Though the constituent elements of the arm’s length principle are regulated in detail, the application of this principle to the individual case remains difficult. It is not unusual for taxpayer and tax administration to be of a different opinion with respect to this application in a given situation. According to experience gained in the past, however, in most cases these disputes can be resolved in consultation with representatives of the local tax office or the representatives of state head in bilateral form. The suggestion was made by some countries in the form of new method called Formulary apportionment, has been a solution suggested to dethrone the arm’s length standard. Currently all United States based multinational corporations are

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244. Para 6.26 of OECD Guidelines
required to declare profits in each separate international tax jurisdiction in which a subsidiary is present. With formulary apportionment a formula would allocate a firm’s total income by determining the percentage of economic activity each subsidiary and parent contributes to the corporation and pay taxes accordingly. This would decrease incentive to move economic activity and income to lower tax jurisdictions because the tax liability of a location is based on the real economic activity. This formula would be measured by a percentage of sales, payroll, property and capital stock if adopted; multinational corporations could no longer manipulate transfer prices for financial benefits. It would also be the end to the strategies used by corporations like Google and oracle and the arm’s length standard. For example in NCS’s situation, NCS was selling material and semiconductor dies to its Asian subsidiary who packaged and sold the products back to NCS at higher prices. NCS then sold their product to customers and recorded a higher profit for the subsidiaries.

This system of Formulary Apportionment is being incorporated in the United States is a plausible option but it would take international cooperation for its successful. If only the U. S. A switch to a formulation apportionment system and the OECD continues with arm’s length pricing, U.S. corporations could face double taxation. However, the European Union has considered switching and along with the United States. Could raise enough support of other countries to make formulation apportionment international standard. The difficulty of setting up such a system could also pose problems for the involved governments and corporations. The entire business structure of these corporations would undergo drastic changes and new accounting standards would have to be put in place. Determining the actual formula and formula weights could pose problems as well. Implementing such an international system is a daunting task and its reward must be compared to its costs.

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246 Morse Susan C “Revisiting Global Formulatory Apportionment” visited at http://works.bepress.com/cgi/viewcontent.cgi?artoc;e=1005&context=susanmorse on 03.03.2015 at 3.30 A.M.

247 Tax policy center op. cit., visited at http://www.taxpolicycenter.org/briefingbook/key-elements/international/formulary-apportionment.cfm on 03.03.2015 at 3 A.M.

248 Durst Michael “it’s not just Academic: The OECD should Reevaluate Transfer Pricing Laws,” Tax justice Network, at http://www.taxjustice.net/cms/upload/pdf/Michael-Durst-summary.pdf visited on 03.03.2015 at 3.30 A.M.