CHAPTER 3:

ALP and MOST APPROPRIATE METHOD:

COMPARABLES and ADJUSTMENTS –

CUP, RPM and CPM

The most important aspect of the applicability of the Transfer Pricing Rules is the determinability of the Arm’s Length Price\(^1\). To determine whether the Transfer Pricing ADJUSTMENT is to be made to an international transaction\(^2\) between associated enterprises, depends upon whether the price is at arm's length or not. ALP is the juice we get after churning comparable uncontrolled prices along with adjustments through different TP method mixie grinders.

In order to appreciate the differences, if any, in the transfer pricing methodology used and/or in its applicability to different set of international transactions, by India, OECD and other countries\(^3\), it is first imperative to understand the methods themselves in their bare form and the relevant comparables and adjustments to be made by using each of these methods. The transfer pricing methods provided under the Indian TP regulations have been comprehensively dealt with in this chapter, whilst other countries\(^4\) methods, et al, have been dealt with in subsequent chapter/s\(^5\).

India has more or less been on the same side of spectrum as far as the number and applicability of the transfer pricing methods is concerned. In fact majority of the countries are in line with the OECD guidelines on the TP methods and are converging towards complete uniformity. Though some aspects still need deliberation as discussed hereinbelow.

---

1 Hereinafter referred to as “ALP”.
2 International Transactions as discussed under Chapter 2.
3 USA, UK, South Korea and Mauritius.
4 Ibid.
5 infra. See generally Chapter 5.
3.1 ARMS LENGTH PRICE (ALP)

3.1.1 Meaning and significance

The principle of arms length price is to be applied to all international transactions in an attempt to achieve the correct price – which the associated enterprises should have reached, assuming the international transaction would have been between unrelated and independent parties under uncontrolled conditions.⁶

Section 92C provides for the Methods of computation of ALP and states –

“Computation of arm's length price .

92C. (1) The arm's length price in relation to an international transaction [or specified domestic transaction] shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe , namely :—

(a) comparable uncontrolled price method;
(b) resale price method;
(c) cost plus method;
(d) profit split method;
(e) transactional net margin method;
(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

[Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices.”

Simply put it is a deal between two unconnected or associated parties, i.e. a price established in a transaction which is entered between two entities, for a product or service independently, and where such entities have no relationship to each other.

⁶ with applicable +- 5% ALP margins as provided under Section 92C(2) of the Act.
Section 92F of the Income Tax Act, 1961 defines the term “Arm’s Length Price” as – “a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.”

Justice Muralidhar of the Hon’ble Delhi High Court unequivocally observed the importance of determining ALP during the course of transfer pricing adjustment holding that, – para “14...The aim of the provisions of Chapter X of the Act is to compute the income in relation to a controlled transaction between an Assessee and its associated enterprise having regard to ALP, in order to nullify the effect of transfer of income to a jurisdiction outside India, if any, in respect of the controlled transactions.”

Para 1.14 of the OECD Guidelines, 2010 provides that the, “OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that arm’s length principle is satisfied.”

The purpose of application of arms length price while making the transfer pricing adjustment is to try and neutralize the condition, which differentiates the transaction price between two associated enterprises on one hand and two unrelated parties on the other hand. Thus it is the most important link in the chain, a link which should be common across the globe and similar in its application in all jurisdictions.

Article 9, Paragraph 1 of the OECD Model Tax Convention 2010 states that, “Where conditions are made or imposed between two associated enterprises in the commercial or financial relations which differ from those which would be made between independent enterprises then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions,
have not so accrued, may be included in the profits of that Enterprise and taxed accordingly.”

A bare perusal of both the Indian Transfer Pricing Regulations (discussed below) and the OECD Guidelines, shows that the determination of arm's-length principle is primarily based on a comparison of conditions in both a controlled transaction as compared against independent enterprises transactions. The chain followed in reaching the ALP is –

**Diagram:**

- Identification of **Tested Party**
- Selection of **Comparables**
- Selection of **Method**
- Carrying out **Adjustments**
- Determination of the **ALP**

### 3.2 **Comparables /Comparability and Adjustments**

A comparability analysis precedes the application of a TP method, while determining the arm’s length price of an international transaction. Moreover, to choose which transactions can be taken as comparable ones, apart from considering product similarity, what is also relevant to be considered are the following comparability factors\(^{10}\), in re the parties –

- Characteristics of goods/services
- Prevailing Market Conditions (Level of market (i.e. wholesale, retail, etc.))
- Contractual Terms

---


\(^{10}\) See also Rule 10B(2) of the Income Tax Act, 1961.
- Volumes of goods/services
- Discounts given or taken
- Exchange Rate fluctuations
- **Duty Differences, subsidies, anti-dumping duties**
- Government policies
- Interest Rates
- Bargaining Power
- Types of intangibles
- **Geographical differences**\(^{11}\)
- Date and time of transaction.
- Date and timing selected for purpose of comparison/drawing comparables\(^{12}\)

More the difference in any one or more of these comparability factors, between the controlled and uncontrolled transaction, the more adjustments are required, creating more divergences in the using of such adjustments. Some of these factors, depending upon the methods adopted, have a major role to play in the comparability analysis and in determining the ALP. For example when considering factors like **characteristics of goods/services** – functional attributes, like appearance, quality, cost, reliability, product information, etc. would have to be seen. While assessing the characteristics of an intangible property – requirements like licensing, type of property- patent, trademark, copyright or know-how, etc. have to be considered.

**Market conditions prevailing** in different jurisdictions with respect to different associated and independent enterprises would have to be borne in mind – like size of the market, cost of labour, geographical location, extent of competition economic development, government regulations, production costs, purchasing power parity and other ancillary economic conditions prevailing. It may be noted several decisions\(^{13}\) have observed that while conducting the FAR analysis\(^{14}\) (Functions performed, Assets employed and Risks assumed), it is not necessary in every case that there be multiple comparables, and the ALP can be determined even on the basis of a single comparable.

---

\(^{11}\) See the concept of “Location Savings”, infra, Chapter 6.

\(^{12}\) See, Liberty Agri Products P/ Ltd. v. ACIT (2011) taxmann.com 174 (Chn-Trib.).

\(^{13}\) Vedaris Technology P. Ltd. v. ACIT (2010) 131 TTJ (Del.) 309; Perot Systems TSI India Ltd. v. DCIT (2010) 130 TTJ (Del) 685; Haworth India P. Ltd. v. DCIT (2011) 140 TTJ (Del) 446

\(^{14}\) Discussed below.
When comparing two transactions, lot of variables (differences) are at play. There usually aren’t two exactly same or similar transactions, which can be taken as comparable ones, and few tweaks and adjustments are requisite so as to be able to properly compare the price between the uncontrolled and controlled transactions. Such tweaks though indispensable in some situations can create lots of deviations when being applied by different countries’ local authorities, due to the underlying differences on account of geographical location, extent of competition economic development, government regulations, production costs, etc. and other such prevailing economic conditions.

The ‘contractual term/s’ factor has a key role in the comparability analysis. Quintessentially, similarity of product and limited adjustments are key to the applications of methods, like the CUP\textsuperscript{15} method; but for adjustments it is an even more imperative factor to take into account – which can be seen in a case for example, where a differential \textit{contractual} payment term and a consequential \textbf{lower sale price}, (due to the existence of a \textbf{corporate guarantee} forming part of the \textbf{contractual terms}), which gives the related party in the controlled transaction more leverage as compared to the independent enterprise in the uncontrolled transaction. The variability arising out of the benefit ensuing from the corporate guarantee needs to be adjusted so as to reach the correct ALP, whilst applying the CUP method, which would necessitate the factoring in of the contractual term while conducting the FAR analysis.

That having been said, it may be highlighted here, that these factors only visualize a ‘\textit{contractual risk}’ instead of deliberating upon a probably more important factor of ‘\textit{controlling risk}.’ Though undoubtedly the contractual allocation of risk is an important factor, but the functioning of entities necessitate that risk undertaken and any corollary risk premiums will go to those entities which are performing the income producing activity relatable to the risk involved.

\textsuperscript{15} Comparable uncontrolled price method.
Therefore even though a contractual allocation of risk is imposed upon an entity, it may not be a relevant factor to consider in case where such entity is a low function entity with no capacity to either control the risk or make any risk-related decisions.\textsuperscript{16} This aspect does not find mention anywhere in the TP provisions.

Before proceeding on to the methods used for the Indian Transfer Pricing Regulation, it becomes extremely relevant to point out that the issue is not merely with the applicability, or one can say non-applicability, of the methods in differing situations but on the presumptive application of the methods disregarding the economic considerations directly linked with risk allotment as envisaged in the contractual arrangements.

This is where one must apply a canon\textsuperscript{17} of, what one may call, a ‘COMMERCIAL RATIONALITY TEST’ which should be applied at every preceding level of application of transfer pricing methods. The ‘commercial rationality test’ would mean, that the reason-d’-itre behind the application of a transfer pricing method, (apart from considering the factors affecting the comparability by conducting the FAR analysis), must mandatorily take into consideration the actual commercial or economic criteria separately identified before choosing the applicable method.

\subsection{3.3 TRANSFER PRICING METHODS}

An oft-quoted saying is that ‘Transfer pricing is not an exact science’; there are no set fixed parameters for arms length price. In order to compute arm's-length price for different transactions, countries have adopted Transfer Pricing Methods.

Under the Income Tax Act, 1961, read with the Income Tax Rules, five such methods for determining the ALP, are prescribed under Section 92C of the Act.

\textsuperscript{16} See for details, Final BEPS Transfer Pricing Report, paras. 1.98–2.06, \textit{supra}, n. 50.

\textsuperscript{17} Also discussed generally in BEPS action plan as well as in some of the countries.
Comparable Uncontrolled Price (CUP)
Resale Price Method (RPM)
Cost Plus Method (CPM)
Profit Split Method (PSM)
Transactional Net Margin Method (TNMM)

Indian TP regulations do not provide any specific hierarchy order of priority for selection of any of the methods\(^\text{18}\) but insist on application of the ‘Most Appropriate Method’ (MAM)\(^\text{19}\). Basically, these 5 methods can be divided into 2 categories\(^\text{20}\) –

- **Traditional Transaction Methods**
  (applicable where simple and direct comparison can be made with little reasonable adjustments) –
  - CUP uses comparison between similar products to reach ALP;
  - RPM uses comparison between gross margins of distributors;
  - CPM uses comparison between gross margins of supplier/manufacturers;

- **Transactional Profit Methods**
  (applicable where complex nature of transactions exist and/or availability of comparable transactions are missing) –
  - PSM uses comparison of net profits earned by the associated enterprises;
  - TNMM compares net profit margins by computing costs in good sales affected and assets employed to reach ALP.

The old OECD guidelines gave precedence to the traditional transaction methods over transactional profit methods but this distinction was done away with in the 2010 OECD guidelines.\(^\text{21}\)

---

\(^\text{18}\) Though OECD, before the revised Guidelines in 2010, gave preference to Traditional Transaction Methods over the Transactional Profit based Methods


\(^\text{21}\) See Para 2.4 of the OECD Guidelines 2010, *supra*, n. 67.
In fact Para 2.4 of the OECD revised Guidelines 2010 provides for instances their transactional profit methods may be found to be more appropriate and reliable as compared to traditional transaction methods; given that in the application of transactional profit methods, especially the TNMM method the profit level indicators are based on ‘net’ income and that these ‘net’ margins are more tolerant to any kind of functional differences that may arise as compared to ‘gross’ profit margins as used in the traditional transactional methods.

Subject to any modification made by the Income Tax authorities and/or Courts, there is absolute freedom to choose from any of the prescribed methods. Briefly stated, CUP requires high degree of product similarity and seeks fewer adjustments, whereas RPM and CPM look for a high degree of functional similarity, with more adjustments required; PSM and TNMM are applied in complex transactions where similarity in products is lacking. More comparables and adjustments are required here.

It is pertinent to note that an amendment in the Rules was made in 2012\textsuperscript{22} and Rule 10AB was added to provide for “\textit{any other method}”.\textsuperscript{23}

\textit{Figure 3.1 and Figure 3.2} below, summarize the TP methods, in a pie chart and flowchart, respectively.\textsuperscript{24}

\textsuperscript{22} Inserted vide (Sixth Amendment) Rules, 2012, w.r.e.f 1.04.2012 (applicable for AY 2012-13 and subsequent years)
\textsuperscript{23} The Delhi ITAT describes it very well in the case of Mitsui Prime Advanced Composites v. DCIT, decided on 28 April, 2016 – “\textit{The ‘other method’ has been prescribed by the Board in terms of Rule 10AB with retrospective effect ITA No.550/Del/2016 from 1.4.2012 applicable to assessment year 2012-13 and subsequent years}.”
\textsuperscript{24} While applying any of the aforementioned 6 methods, regard should be had to Rule 10C of the Income Tax Rules.
Figure 3.1

Figure 3.2
3.4 COMPARABLE UNCONTROLLED PRICE METHOD (CUP)

The simplest and direct way to achieve arms length price is through the application of the Comparable Uncontrolled Price Method. A comparable uncontrolled price would be an uncontrolled price, agreed between unrelated parties for a transaction, which in all material respects is comparable to the transaction between the associated enterprise/s25.

3.4.1 Working

Rule 10B(1)(a) enunciates this method; Once it is established that any difference in financial or commercial conditions has been accounted for by making necessary adjustments, the price charged in the uncontrolled transaction is substituted for the price charged in the controlled transaction, and this price so arrived at by applying the CUP method is the arm's-length price of the controlled transaction.

To ascertain a comparable set of transaction/s, the method can be used in two ways – INTERNAL CUP (ICUP) and EXTERNAL CUP (ExCUP).

In ICUP, data of the tested party’s transactions with unrelated enterprise/s is taken. ExCUP on the other hand involves usage of data from transactions between two completely independent Enterprises.

ICUP application involves the use of ‘exact comparables/Internal comparables’, since there is an exact comparison of transactions, which are similar to the third party as with the associated enterprise/s. In ICUP, the transactions are with regard to the tested party, where the uncontrolled transaction/s of the tested party are with unrelated enterprises. ICUP is usually preferred given the close proximity of similar comparables available for the controlled and uncontrolled transactions.26

26 Birlasoft (India) Ltd. v. DCIT, (2011) 9 taxman.com 263 (Delhi), The Delhi Income tax Appellate tribunal, while determining the ALP of international transaction involving providing of software development and related services, held that in a case where instances of internal comparables are available any recourse taken to external comparables would not be justified. See also, VVF Ltd., DCIT, (ITA No. 673, Mum Trib); Contra case : Ghardia Chemicals Ltd., v. DCIT, (2010) 35 SOT 406.
ExUP on the other hand is usually used where ICUP data is unavailable, i.e., where the tested party has no documented transaction with any unrelated party for the same or similar transaction.

### 3.4.2 Relative Accuracy

Though being one of the easiest methods given its straightforward comparison between the price set in a controlled transaction qua a price set in an uncontrolled transaction between independent enterprises; but its entire application is based on a single important assumption of *product similarity*.

The special bench of the Bangalore Income Tax Appellate Tribunal\(^\text{27}\) observed the indispensability of an identical transaction when applying the CUP method – “CUP method is essentially comparison of prices charged for the property or services transferred in a controlled transaction to a price charged for property or services transferred in a comparable uncontrolled transaction. The bedrock of this method is the identification of an identical transaction, in a situation where the prices charged for products or services between unrelated parties.”

By choosing the price from the comparable uncontrolled transaction, CUP assumes that the sale or purchase made in the said uncontrolled transaction, is of a similar good, and that by making few accurate adjustments any distinction from the similarity could be reduced. An enterprise or party should choose the CUP method only in cases where the material affects of any difference can be eliminated by making as few adjustments as possible. The efficiency of this method reduces as the differences in the product increase.

### 3.4.3 Usual Application

It is the *similarity of the underlying goods and services which is fundamental to the application* of the CUP method.\(^\text{28}\) As V.S. Wahi puts it, that CUP method can be best applied where there exists a “*close similarity of controlled and uncontrolled transactions and availability of reliable external data in public domain*”\(^\text{29}\)

---

\(^\text{27}\) Aztec Technology Services P. Ltd. v. ACIT, (2007) 162 Taxman 119 (Bangalore Trib.) (SB)


\(^\text{29}\) *ibid*, p. 149.
CHAPTER III

Given the essential condition of product similarity the application of this method is restricted to cases of sale of goods, intragroup financial transactions, say interest charged on a loan, provision of services, transfer of intangibles, etc. Royalty payments and software development licensing are rather common situations where CUP is applied. CUP can even be applied to case of and enterprise giving out the corporate guarantee to a related enterprise, but only where cogent and reliable evidence of similar guarantee rates of banks is available in the public domain.

Situations where CUP method can be applied is whether taxpayer buys or sells same/similar goods/services under similar terms and conditions from an independent enterprise; OR where an independent enterprise buys or sells same/similar goods/services under similar terms and conditions from another independent enterprise.

The UN Transfer Pricing Manual observes that, “the CUP method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction.”

3.4.4 Comparability and Adjustments under CUP Method

Now considering the difference in these comparability factors as mentioned above, a suitable adjustment needs to be made in the price to account for such differences. CUP’s unique selling point is that due to the threshold condition of product similarity, minimal adjustments are required thereafter. Apart from significant comparability requirements of market, payment terms and cost and delivery, “product comparability is absolute key, in particular, physical features such as size, weight and appearance along with volume, reliability, storage requirements, regulatory requirements and the like.”

---

As stated above, the standards and degree of comparability for CUP are extremely high. Since while using this method it may be extremely difficult to find a similar or same kind of transaction, a potential comparable may be lost. To avoid this, adjustments for accountable differences are carried out. If either any such differences are not likely to materially affect the price charged in a similarly placed open market transaction, or if reasonable adjustments can be made to eliminate a material difference, CUP can be applied.\textsuperscript{32}

### 3.4.5 CASE LAWS

This segment shows where and how the CUP method has been applied as the MAM (Most Appropriate Method) by the Indian income tax authorities for the given international transaction/s.

**Serdia Pharmaceuticals P. Ltd. v. ACIT\textsuperscript{33}**

Facts of the case were that the assessee was engaged in the business of producing drugs and imported raw material API (Active Pharmaceutical Ingredients (APIs) from the AE. It adopted the TNMM method, which was rejected by the TPO, who applied the CUP method, by gathering information regarding APIs purchased by other similar producer enterprises.\textsuperscript{34} The ITAT rendered the judgment against the assessee holding that the CUP is the most appropriate method in respect of purchases of a generic drug since the selling price of the other said APIs (in the Indian market), constitutes good comparables.\textsuperscript{35}

**Outcome** - CUP used as MAM for the International Transaction of sale and purchase of pharmaceutical drugs or APIs for generic drugs.


\textsuperscript{33} (2011) 9 taxmann.com 13 (Mum-Trib.).

\textsuperscript{34} See also contra case, \textit{UCB India 2010 Mum Trib decision}, *supra*, n.

\textsuperscript{35} Serdia Pharmaceuticals has been followed by the Pune Tribunal in \textit{Henkel Adhesives Technologies India Private Limited v. DCIT}, (2014) 39 CCH 414 (Pune Trib)
**DCIT v. M/s 3 Global Services P. Ltd.**

The Company was engaged in rendering of provision of software services to its AEs. The tribunal upheld the application of CUP method and accepted assessee’s comparable providing details of rate charged by specific companies providing similar voice-based software services. It rejected the TPO’s application of TNMM method and comparables categorizing them to be under entirely different segments and incomparable with the taxpayer's case.

**Outcome - CUP used as MAM for the International Transaction of rendering software services, based on product similarity between comparables.**

---

**Gharda Chemicals Ltd. v. DCIT,**

The transaction under scrutiny was where the assessee had sold a product to its wholly owned subsidiary in USA. The Mumbai Tribunal in this case, rendered an interesting judgment by rejecting both the external comparable as used by the assessee as well as the internal comparable used by the TPO. It rejected the external comparable of the assessee, being a third-party report consisting of a similar transaction of sale by a Chinese company for the same product to USA, lacking authenticity and not being in any ‘quotation media’ or public domain; and ultimately went ahead and applied the TNMM method.

The TPO used an internal comparable relating to transactions of the Indian assessee with respect to the same product to other unrelated Enterprises in other countries, which was also rejected by the tribunal on the **ground of geographical differences between USA** and other stated unrelated countries, since it would make the application of such a comparable in CUP method unsuitable.

---

37 Also see - **ACIT v. Dufon laboratories,** (2010) 39 SOT 59 (Mum Trib);
For contra case see **Aztec Software and Technology Services P. Ltd. v. ACIT,** (2007) 162 Taxman 119 (Banglore Trib) (SB) – where in a case of software development services, the Industry average rate or the NASSCOM rate could not be adopted for comparison using CUP method, since they were not identical transactions.
38 (2010) 35 SOT 406 (Mum Trib.).
39 For conditions to check veracity of the data for comparables, see R. 10D(3) of the Income Tax Rules, 1962.
CHAPTER III

Outcome - CUP not used as MAM for the International Transaction of sale of product/s to wholly owned subsidiary (in USA), due to non-availability of proper comparables given the geographical differences.

*Amphenol Interconnect India P. Ltd. v. DCIT*\(^4^0\)

The assessee company was mainly engaged in the business of manufacturing of cable assemblies and accessories and had entered into international transactions with AEs for purchase of raw material. TPO’s CUP method’s application was rejected\(^4^1\) since he had considered only the product similarity without taking into consideration other variable factors (without which suitable adjustments were not possible) like market competition, volume and timing of the order and importantly the geographical location of the purchasing customer.

Outcome - CUP not used as MAM for the International Transaction international transactions with AEs for purchase of raw material, due to non-availability of proper comparables, among others including on account of geographical differences\(^4^2\).

*ACIT v. Clear plus India P. Ltd.* \(^4^3\)

The assessee was engaged in the business of manufacture and supply of wipers used in the motor vehicles to its AE (USA). The Delhi High Court, in a department's appeal against the Delhi Tribunal’s decision, upheld the application of CUP method and rejected the TNMM method on the ground that the reference companies taken by the TPO/Department were large companies having substantial turnovers\(^4^4\) and could not be taken as viable comparables as compared to the small assessee company. CUP was applied after taking other small companies as comparables being in similar product business of manufacture and supply of wipers.

Outcome - CUP used as MAM for the International Transaction of manufacture and supply of products.

---

\(^4^0\) [2015] 67 SOT 346 (Pune - Trib.)(URO)/[2014] 165 TTJ 105 (Pune - Trib.).
\(^4^1\) TNMM Method eventually used.
\(^4^2\) Also see on the issue of geographical differences - ACIT v. Vistaaar Systems P. Ltd., (2013) 33 taxmann.com 445 (Mum-Trib); Ranbaxy Laboratories v. ACIT.
\(^4^3\) Delhi High Court ITA No. 1105/2011; Also see *Clear plus India P. Ltd. v. ACIT* (Delhi Tribunal decision), (2011) 10 Taxmann.com 249 (Del Trib).
\(^4^4\) Also see *ACIT v. Vistaaar Systems P. Ltd.*, (2013) 33 taxmann.com 445 (Mum-Trib).
3.5 RESALE PRICE METHOD (RPM)

The resale price method uses on a comparative scale the gross margins (i.e. gross profit over sales) realized in both controlled and uncontrolled comparable transaction, while identifying the resale price. Unlike in the preceding CUP Method, the RPM lays more emphasis on the similarity of functions performed by the tested party and the comparable entity, rather than similarity of products between the two. Though like CUP, it's a direct method comparing the gross margin on in transactions both between related and independent entities.

An aspect to be borne in mind while applying this method is its restrictive application wherein either the distributor/reseller does not add any significant value to the product; though adjustments may be possible to take into account the value additions but the stakeholders are then careful to use other methods in place of RPM.

The method simply involves taking into consideration the purchase price of the product from an AE as compared to the resale price provided to an independent enterprise. Once the resale price is determined it is thereby reduced by an appropriate gross margin, or as is usually referred to a ‘Resale price margin’, which is the figure representing a profit margin and other ancillary expenses while making the resale.

This difference once reduced from the resale price gives us the arm's length price, which can then be compared to the product price of the AE and an appropriate transfer pricing adjustment may be made. The difference should include allowing the reseller to recover its operating costs and some amount of profit which it may earn on the resale.46

Rule 10B of the income tax rules provides for determination of ALP under this method. The resale price margin is the margin that the reseller earns on the same items from a comparable uncontrolled transaction from unrelated parties. Two types of mark-ups – Internal mark-up and External mark-up – can be used while applying

45 Hereinafter referred to as RPM.
46 Margin of profit may depend upon the functions performed, assets used and the risks assumed (FAR Analysis).
this method. In the former, the distributor/reseller price/margin earned on resale to an independent entity is compared with the controlled transaction; And in the latter, the purchasing and the reselling margins of completely independent parties’ transactions with each other are compared with the controlled transaction.

For eg., the resale price margin earned by one company (member) of a group (of companies) in comparable uncontrolled transactions, could be used as an Internal Comparable;

Similarly, the resale price margin earned by one separate independent entity (not part of the group, but having a similar transaction) again in comparable uncontrolled transactions, could be used as an External Comparable:

**INTERNAL MARK-UP / INTERNAL COMPARABLE –**

I Ltd. being a distributor Co. and the tested party purchases from AE and resells to the independent enterprise; if RPM is to be applied, then, B needs to be similar to A (within a ± 5% profit margin\(^47\), and plus additional mark-up for profits and/or extra costs for resale\(^48\)) otherwise suitable transfer pricing adjustment may be undertaken.

**A is compared to B (while using Internal mark-up)**

\(^47\) ALP Margin.

\(^48\) Of course suitable adjustments that we made to take into account the profit margin and recovering of any operating costs by the reseller/distributor to the retailer.
EXTERNAL MARK-UP / EXTERNAL COMPARABLE –

In a similar factual situation -

**B & Y are respectively compared, keeping in mind A & X respectively, (while using External mark-up).**
Usually as the practice goes, the internal markup is preferred over the external mark-up, and re-sales made by the distributor/reseller itself to independent entities would have precedence over completely comparable independent transactions, in similarly placed circumstances where the comparable independent enterprise is also performing similar functions as the distributor/reseller.

The straightforward reason for this is that there would be more similarity in characteristics of the transaction when the reseller itself is making re-sales of the product, and RPM could be easily applicable; as compared to completely independent resales made by independent distributor/reseller enterprises, performing similar functions. The external comparable is usually used in absence of a comparable uncontrolled transaction involving the same reseller.

The special bench of the Bangalore Tribunal in the case of *Aztec Software and Technology Services Ltd. v. ACIT*[^51^], sums it up by observing that – “The RPM is to be applied when a property purchased or services obtained from an associated enterprise is resold to an unrelated enterprise. The RPM is based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise.”[^52^]

The resale prices are reduced by appropriate resale price margin for arriving at the ALP. The deductions to be made from the Resale price of goods are the (direct) expenditure as also the *normal gross profit margin*, which deductions would have been made on it in the ordinary course by an unrelated enterprise in a similar transaction. Further adjustments to the price may have to be made keeping in mind the different accounting practices and/or any other material differences between the transactions. Similar to the CUP method, there may be an internal RPM or external RPM. Benchmarking of these given margins, needless to say, is critical in this process, while ascertaining the ALP.

[^49^]: See in this regard - *Mattel Toys P. Ltd v. DCIT*, (2014) 30 ITR (Trib) 283 (Mum.).
[^50^]: Deloitte, 2015, 4th ed., supra, n. 21, at p. 179.
[^52^]: *ibid*, para 119.
3.5.1 Usual Application

The most frequent applicability of this method is where the tested party is a distributor which involves transactions incorporating selling and distribution functions. This method is most suited to measure the value of services that are performed by a reseller acting as a distributor in cases where the reseller does not add any significant value to the products it resells.\(^{53}\) RPM can be best applied in cases of minimal processing at time of resale, where the reseller adds relatively little value to the product such that identity of the product cannot change from semi-finished to a finished one. Its applicable accuracy increases and is ideal for distribution activity; in cases where a product is purchased by the tested party from the AE and resold to an independent enterprise.

The special bench of the Bangalore Tribunal in the case of *Aztec Software and Technology Services Ltd. v. ACIT*\(^{54}\), while ascertaining the applicability of RPM held that, “RPM could be a reasonable method to apply to transactions involving resale of tangible property or in cases where the services are resold without value addition. This method is particularly suitable in cases where goods are sold within a short period of purchases and influence of other factors is found to be minimal”

While using the RPM method, similar distributor functions of some products of everyday usage like electronic items - televisions, computers, mobile phones, air conditioners, refrigerators, can be grouped together for comparability analysis. The distributors of these products may perform similar selling functions despite physical difference between these products.\(^{55}\) The minimal requirement of a high level of functional comparability makes it more) applicable to where the tested party/controlled party is a distributor.\(^{56}\)

Caution must be maintained in not applying RPM where the reseller may use his own intangible asset to add value to the product, since the difficulty of determining the appropriate reseller margin (for comparability) increases with the amount of

\(^{54}\) Aztec Software case, *supra*, n. 110.
\(^{56}\) Deloitte, 2015, 4th ed., *supra*, n. 21, p. 176
value addition made to the goods by the use of such intangible assets or otherwise. But as long as there is little or no value addition, when choosing between RPM and (say) CPM, the RPM method would still assume precedence since a fee/royalty for technical services using intangible assets can be determined more closely and easily by using the RPM method, given that it would be ‘exceedingly difficult to determine costs involved in developing technological know-how’ by using any other method than RPM.  

3.5.2 Comparability and Adjustments under RPM method

In the RPM Method, since comparability is adjudged between the controlled and uncontrolled transactions based on the margin rather than the product itself, minor product differences are unlikely to have a material effect. Corollary speaking while making a functional and economic analysis, adjustments are required in this method to account for any differences as long as there is deep similarity in the functions performed. At the cost of repetition it may be stated that the gross margin being compared also importantly includes the operating profit which is akin to a compensation in return, i.e., – for any capital investment, to recover its operating costs, risks undertaken, assets employed, etc.

As product differences are less likely to have any material effect on the profit margin as it had on price (under this CUP method), product similarity itself may not be a factor to consider; But how the product is dealt with in the resale chain and what functions are performed with the product are clinching factors which assumes significance while making any adjustments while applying this method. The similar functions performed by the distributor/reseller even qua different products may be considered.

The difference in the margins increase with the increased level of commercial activity being performed by the reseller – the more elaborate the functions the distributor performs the more margin he deserves and receives, which would have to be taken

57 Deloitte, 2015, 4th ed., supra, n. 21, p. 178
58 Wahi, 5th ed., 2013, supra, n. 12, p. 150.
into consideration while making appropriate adjustments in the application of the RPM method, while determining the ALP for the transaction in question.

Thus, what is to be borne in mind are factors like – and adjustments be carried out to eliminate the differences caused by such factors like –

- Addition of any significant value to the product, if any.
  Especially to the extent of creation of an intangible property, embedded in the resold product; or where the distributor has used own in tangible property to add that significant value to the resold product.60;

- Level of activities performed by the reseller (like whether reseller working at the mail forwarding agent providing minimal services or on the other hand being burdened by risks of advertising marketing and promotion in addition to any ownership or warranty risks);

- The functions the distributor performs – being only distributor functions or being engaged in other substantial commercial activities;

- Differences in the market conditions like exchange rate fluctuation, ancillary costs, accounting practice differences, etc.;

- Time gap between the distributor purchasing the goods and reselling the same.

- The distributor bearing special risks, if any;

- Contractual terms like a warranty clause, transportation terms, purchase volumes, mode of payment, cash discounts61 and ancillary incentives, outward freight charges and storage expenses62, etc.;

- Ownership of any tangible property like trademark.

- After (re-) sale services;

- Level of market (wholesale or retail);

- The distributor/reseller possessing any exclusive right of re-sale;

- Geographical differences between the manufacturer and distributor;

- Relative competitiveness in different markets or different jurisdictions;

- Costs relatable to resale, like costs of R&D, advertising marketing and promotional expenses, etc.;

---

60 “However for this purpose any job in regard to packaging, labelling or minor assembly of goods cannot be regarded as activity in respect of physical alteration to goods sold.” see Wahi, 5th ed., 2013, supra, n. 12, p. 153.

61 See in this regard, Panasonic Sales and Services Co. Ltd. v. ACIT, (2014) 40 CCH 707 (Chn.) Trib.

62 Ibid, generally.
- Inter-se product competition in intra-jurisdictions and inter-jurisdictions;

Apart from other activities being performed and the risks undertaken under the contractual terms between the distributor and the other respective party, one of the important terms in some of such contracts is – the Exclusive right to resell the goods/products.

Variance in the resale price margin can sometimes be exclusively attributed to such a contractual term. This term may find itself embedded not only in the case of the tested party/distributor but also in any one of the comparable uncontrolled transactions between unrelated entities. The quantification of such variance due to such a term may depend upon the jurisdictional/geographic applicability, relative bargaining power of the related or unrelated enterprise, consequential monopolies being created, inter-se and third-party competitiveness qua other similar products/goods in the different jurisdictional markets, et al.

While conducting the comparability analysis, as stated above, the use of internal comparables is much more prevalent as compared to external comparable. Independent third party sales and re-sales made by the distributor may not be best comparables for applying the RPM method, regardless of being carried on in completely uncontrolled transactions. The reliability of an internal comparable – of a distributor itself making uncontrolled re-sales of the same product purchased in the controlled transaction under the scanner, is much more relevant. The use of external comparables over internal comparables must be made only in cases where the transactions involving the same reseller are entirely absent.\(^63\)

Regard must be had to the operating expenses and/or the cost of sales, while drawing out comparability between the related and unrelated transactions. “The more comparable of functions, risk and assets, the more likely that the RPM will produce an appropriate estimate of an arm's-length result.”\(^64\)

\(^63\) Deloitte, 2015, 4th ed., supra, n. 21, p.179.
\(^64\) ibid, p.185.
3.5.3 CASE LAWS

1. *ITO v. L’oreal India P. Ltd*\(^6^5\)

The assessee was engaged in the business of *sale and purchase* of cosmetic consumer products. The instant case is an example of the RPM method being applied where the transaction fulfilled the basic criteria in relation to the method’s adoption since the Assessee purchased the goods from the AE and sold it to unrelated parties, importantly, without making any substantial value addition. Importantly the application of the RPM method in such situation shows this similarity between its adoption by the Indian tax courts (as seen above) as well as the OECD guidelines under which the RPM method is the standard method to be adopted in case of distribution or marketing activities where the goods are purchased from AEs and sales are effected to unrelated parties without any further processing and/or value addition.

**Outcome** – RPM adopted as MAM for the International Transaction of *sale and purchase* of cosmetic consumer products, where NO further processing and/or value addition.

2. *Mattel Toys P. Ltd v. DCIT*\(^6^6\)

The assessee company was engaged in marketing, distribution and selling of toys and games imported from its AE. The Mumbai Income Tax Appellate Tribunal in the given case elucidated upon the circumstances in which the RPM method can be adopted – “The RPM method identifies the price at which the product purchased from the A.E. is resold to an unrelated party. Such price is reduced by normal gross profit margin i.e., the gross profit margin accruing in a comparable controlled transaction on resale of same or similar property or services.”

The Tribunal observed that the RPM is mostly applied in a situation in which the reseller purchases tangible property or obtains services from an A.E., and

\(^{65}\) (2012) 24 taxmann.com 192 (Mum.); This Case has since been affirmed in [2015] 53 taxmann.com 432 (Bombay) by the *Bombay High Court*.

\(^{66}\) (2014) 30 ITR (Trib) 283 (Mum.).
reseller does not physically alter the tangible goods and services or use any intangible assets to add substantial value to the property or services i.e., resale is made without any value addition having been made. Therefore, in such a situation, the nature of products has not much relevance, though their closer comparable may produce a better result.

The focus is more on same or similar nature of properties or services rather than similarity of products. The main reason is that the product differentiation does not significantly affect the gross profit margin as it symbolizes gross compensation after the cost of sales for specific function performed. “The *functional attribute* is more important while undertaking the comparability analysis under this method...In such a situation, RPM can be the best method to evaluate the transactions whether they are at ALP.”

**Outcome** – RPM adopted as MAM for the International Transaction of marketing, distribution and selling of toys and games imported from its AE despite dis-similarity in comparable products, since *no physical alteration to the tangible goods and no substantial value addition made.*

3. *Sanyo India P. Ltd. v. ACIT*[^68]

The court held that RPM method was the most appropriate method to be applied by the assessee and to the transactions of the assessee, i.e. Sanyo India, who was a full-fledged distributor of consumer durables. It imported the goods from its associated enterprise and sold it in the domestic Indian market without making any kind of value addition, except for packaging in tune with the local laws.

**Outcome** – RPM adopted as MAM for the International Transaction of distribution of consumer durable goods, since NO value addition made.^[69]

[^67]: *ibid*, Para 38.
[^68]: ITA No. 1022(B)/2012.
3.6 COST PLUS METHOD (CPM)

This method looks at the cost factor to arrive at the ALP. It determines the ALP by taking into consideration the AE’s (associated enterprise’s) costs, both direct\(^{70}\) and indirect\(^{71}\), and adds to it an appropriate gross profit margin.

This gross profit margin includes the margin/return on the transaction and is to be determined from a comparable uncontrolled transaction after subjecting the same to the FAR analysis – functions performed, assets employed, and risks assumed. “Under this method, the margin earned by the seller/supplier is benchmarked against margin earned in comparable uncontrolled transactions and in addition against the margin earned by independent enterprises.”\(^{72}\)

Unlike in the RPM method the focus in CPM method, is on the supplier rather than the distributor, and is on the AE rather than the tested party/Assessee; while applying RPM the re-sale price of goods purchased is to be considered and while applying CPM purchase cost of the goods sold is to be considered. That having been said, both the RPM and CPM follow the ‘Functional Similarity rule’\(^{73}\) while analyzing comparable transactions.

Needless to add here as well, that internal comparables are preferred over the external ones while applying this method. Wherever the markup of the uncontrolled transaction of the tested party is available it is to be taken for consideration and where not external comparable transactions can be looked at. VS Wahi rightly points out that accounting consistency becomes a necessity since Cost-plus Mark-up is usually the gross margin, which covers general, administrative and selling expenses allowing an

---

\(^{69}\) Also see in this regard Danisco India P. Ltd. v. ACIT, TS-169-ITAT-2014(Del)-TP, where the assessee while reselling the imported goods, did not make any value addition, the tribunal held in favor of adopting the RPM method.

\(^{70}\) Direct costs may include labours and material, etc.

\(^{71}\) Indirect costs may include overheads, etc.

\(^{72}\) Wahi, 5th ed., 2013, supra, n. 12, p. 162.

\(^{73}\) Transactions taken for comparison are those where there is functional similarity between the two transactions/unrelated and related entities.
appropriate net margin to be added. “Sometimes it may be more accurate to consider some intermediate profit level in order to make comparisons on a consistent basis”\textsuperscript{74}

Costs to be calculated for the purposes of using this method, includes both the direct and indirect costs, as is specifically provided under the provision of the income tax rules\textsuperscript{75}. An important aspect to be considered during the application of this method is the identification and allocation of costs to be taken into account while determining the appropriate ‘Mark-up’. The comparison is made based on the markup on costs achieved by the controller supplier of goods/services as compared to the markup achieved by the uncontrolled entities on their own costs in relation to the comparable transactions.\textsuperscript{76} The determination of costs under this method has sometime proven to be difficult given its high variance over the years, which makes the determination of the appropriate profit margin for one year, a challenging matter.

The Mumbai Appellate Tribunal in the case of \textit{Essar Shipping Ltd. v. DCIT}\textsuperscript{77}, while applying this method observed that the word is ‘Gross Mark-up’ and therefore gave it an expansive meaning so as to say that nothing should be reduced from the costs.\textsuperscript{78} It is imperative to point out that while arriving at the ‘costs of production’ for the two inter-se set of transactions, the same must be determined in a consistent manner.

The OECD guidelines provide some assistance in this regard in relation to the principle of historical costs and averaging costs.\textsuperscript{79}

\textsuperscript{74} Wahi, 5\textsuperscript{th} ed., 2013, \textit{supra}, n. 12, p. 165.
\textsuperscript{75} Rule 10B(1)(C) of the Income Tax Rules 1962.
\textsuperscript{76} Deloitte, 2015, 4\textsuperscript{th} ed., \textit{supra}, n. 21, p.191.
\textsuperscript{77} (2009) 27 SOT 409 (Mum.).
\textsuperscript{78} The TPO’s rejection of adding into costs the reduced dividend from payments made to associated enterprises while determining ALP, was not held to be justified.
\textsuperscript{79} OECD Guidelines 2010, supra, n. 67.
3.6.1 Usual Application

Cost Plus method is the go-to method in cases of contract manufacturer and supplier. The method is suitable for being used in manufacturing activity and can be applied in transactions involving semi-finished goods being sold between related parties in similar transactions and/or in case of parties entering into joint facility agreements and long-term buy and supply arrangements, or even in circumstances where the controlled transaction between the related parties is for provision of services.\(^80\)

A typical example of a contract manufacturer could be where, an enterprise X possesses the intangible property, know-how, etc., and enterprise Y\(^81\) merely compiles and puts together the product, that too at the expense and risk of enterprise X; in such a case the enterprise Y exhibits a purely contract manufacturing function. R&D work is carried on by the Enterprise X and any substantive risk of R&D failure is also assumed by enterprise X.

So CPM can be applied to –

a) transactions relating to semi-finished goods;

b) joint facility agreements;

c) and long-term buy and supply arrangements; or

d) controlled transaction between the related parties for provision of services.

The most typical and habitual application of this method is where the tested party is a contract manufacturer\(^82\) — wherein the company undertakes to manufacture product/s or provision of services for which the specifications\(^83\) for the products/services is provided by the main manufacturer. The manufacturer is in possession of possibly the intangible property, and/or the technical know-how required to produce the goods, which it may choose to transfer or license it out to the tested party/contract manufacturer.

---

81 Which is a 100% subsidiary of Enterprise X
82 See in this regard - DCIT v. GEBE P. Ltd., [2014] 64 SOT 129 (Bangalore - Trib.) (URO) / [2014] 164 TTJ 40 (Bangalore - Trib.).
83 Similar to a “contract for service” under the Indian Contract Act, 1872.
As seen here in the Indian TP regulations, in the adoption of the CPM method, the provisions are in sync with OECD Guidelines which also provide that the CPM method is the best suited method to be applied wherein the tested party’s function can be described as a purely contract manufacturing function. 84

Such a contractual arrangement entails minimal market risk in the eventual selling of goods/provision of services. Given the lower risk and earning of a lower return on costs of its operations, CPM is the ideal method to be applied to such transactions. “The CPM maybe the best method if the producer provides more complete data than does the distributor. This method is ordinarily used for the manufacture, assembly or other production of goods that are sold to related parties.” 85

In fact, in such a situation where the contract manufacturer is not bearing any risk, (including that of marketing), then there would be no consequential expenditure on any AMP expenses 86 and therefore would be no need for making a provision for such costs while applying CPM. 87

3.6.2 Comparability and Adjustments under CPM Method

As stated above, both the RPM and CPM method share the importance of comparing transactions having FUNCTIONAL SIMILARITY; and for reaching this comparability, the FAR analysis is critical. “…the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices.” 89

84 Review of comparability and of profit Methods: Revision of Chapters I-III of The Transfer Pricing Guidelines, CTPA CENTRE FOR TAX POLICY AND ADMINISTRATION, 22 July 2010, para 2.54.
86 Advertising, marketing and promotion Expenses;
87 TNMM is usually the prescribed method when such comparable Advertising, marketing and promotion Expenses are to be taken into consideration in controlled and uncontrolled transactions between related and unrelated entities.
88 Functions performed, assets employed and risks assumed.
Though product similarity is not as essential in the CPM method as required in the CUP method, but sometimes significant differences between the product/s may highlight legitimate functional differences too and could make the uncontrolled comparable as an unreliable indicator.

The gross profit margin of the assessee/tested party must be calculated comparing the markup as earned by the comparable enterprises; i.e. applying a comparable markup to a comparable cost basis. When comparing costs and gross profit margin – one needs to take into account all those costs in respect of ‘**similar level of services**’ provided to the unrelated parties in comparable uncontrolled transactions. For eg., a competitive cost analysis cannot be made (at least not without requisite adjustments) between an entity/supplier employing **leased business assets** while carrying out its activities as compared to and entity/supplier carrying out its activities through its **owned business assets**.\(^9\)

Not only does one have to consider the similarity in the level of services; but also the level and types of **expenses** associated with the FAR analysis also have to be taken into consideration. The expenses could be operating, non-operating or financing expenditure, as the case may be. The difference in the level and/or type of such expenses reflects the functional\(^91\) or structural difference\(^92\) for which appropriate adjustments need to be carried out; Though any sort of difference in expenses in carrying out any administrative and/or general/supervisory activities need not be taken into account for the purposes of adjustment.

Following factors need to be considered when requiring Adjustments to gross margins and for a comparable Supplier analysis –

a) Leased business assets or owned business assets.

b) Ownership of **intangibles**\(^93\) and its value thereof\(^94\)

c) marketing functions/operations

---

\(^9\) Deloitte, 2015, 4th ed., *supra*, n. 21, p. 191-192

\(^91\) Based on assets employed and risks assumed.

\(^92\) Expenses relatable to capital structures affecting the arm's-length arrangements

\(^93\) Patent, copyright, trademark, know how or domain knowledge, etc.

\(^94\) Since where there is a well-recognised trademark obviously the gross profit margins would vary significantly.
• R&D (if any);
• Product design;
• Process engineering - manufacturing and production;
• assembly function (product fabrication, extraction, etc.) and its complexity;
• marketing services;
• transportation services, warehousing etc.;
• management training and ancillary services;

d) Risks undertaken

e) Business experience and size of business operations - also relatable to market reach and brand equity (start-up entity, developing entity, or market dominator);

f) Age of plant and machinery (may affect cost structures)\(^95\)
g) volume discount/quantity discount
h) Contractual terms
i) Foreign currency risks
j) credit facility in respect of billing amounts
k) Management efficiency

What is also to be borne in mind is that the functional differences are not directly proportional to the effect of these differences on the gross profit nor would they be having an exactly proportional impact on the related expenses.

### 3.6.3 CASE LAW

**GEBE P. Ltd. v. DCIT\(^{96}\)**

The assessee, a contract manufacturer, manufactured components of medical devices and sold it to its AE. The Bangalore special Tribunal held the **CPM method as the most appropriate method in the cases of contract manufacturers**, placing reliance

\(^{95}\) May include cost of producing as well as including cost of acquiring property for resale.

\(^{96}\) supra, n. 140.
upon that Indian transfer pricing provisions, the UN Practical Transfer Pricing Manual Guidelines as well as the OECD Guidelines. The UN Practical Transfer Pricing Manual for developing countries, 2012, in Para 6.2.20.2 and 6.1.3.3 lays down the guidelines for selection of MAM, and provides for adopting CPM as the MAM in case of contract manufacturers like the case of the assessee. The OECD Transfer Pricing Guidelines under Para 2.2 and 2.53\textsuperscript{97} fortify the use of CPM as MAM in such facts and circumstances.

Thus there is a broad uniformity in the application of the CPM method as the MAM in cases of international transactions where the tested party/assessee is a contract manufacturer.

That having been said the case did highlight a key point of divergence – that is the option of using more than one transfer pricing method to ascertain the arms' length price of a related party transactions, as prescribed under the OECD guidelines as well as the UN TP Manual; which is in stark contrast to the Indian TP Rules which advocates the use of ONLY ONE TP method as the ‘the Most Appropriate Method’ (MAM). The tribunal held that,

\begin{quote}
\textquote{“Hence, the assessee's contention of using TNMM as an alternate approach or method was not in tune with the Indian TP Rules, even though it may be permissible as per OECD guidelines. As per the Indian TP Rules, the assessee is to select one method as the MAM. The Indian TP Rules do not give any scope or leverage to use different TP methods.”}\textsuperscript{98}
\end{quote}

The tribunal concluded that the use of more than one method sought by the assessee was not in tune with the Indian TP Rules, though having found support in both the OECD guidelines as well as the UN TP Manual.

This indeed thus becomes a point of concern, given that even in areas of convergence on the application of method, there still persist divergent ideologies in regard to the number of methods used.

\textsuperscript{97} OECD Guidelines 2010, \textit{supra}, n. 67, at Para 2.2 and 2.53.

\textsuperscript{98} GEBE P. Ltd. v. DCIT, \textit{supra}, n. 140, See para 44-46.
3.7 CONCLUSION

This chapter elucidates upon the most important aspect of the applicability of the Transfer Pricing Rules which is the determinability of the Arm’s Length Price. To determine whether the Transfer Pricing adjustment is to be made to an international transaction between associated enterprises, depends upon whether the price is at arm's length or not. It provides the Traditional Transaction Methods, which are applicable where simple and direct comparison can be made with fewer reasonable adjustments –
— CUP uses comparison between similar products to reach ALP;
— RPM uses comparison between gross margins of distributors;
— CPM uses comparison between gross margins of supplier/manufacturers;

This chapter establishes the purpose of application of arms length price while making the transfer pricing adjustment, which is to try and neutralize the condition that differentiates the transaction price between two associated enterprises on one hand and two unrelated parties on the other hand.

It details out the comparability analysis which precedes the application of a method. The analysis takes into considerations several factors like product similarity, Prevailing Market Conditions, Contractual Terms, Types of intangibles, Geographical differences, and more. The analysis then leads to the methods’ application specific to certain given situations. For eg., CPM Method to be used in cases of Contract manufacturer being the tested party.

The chapter highlights that the multinational corporations take advantage of the difference in the said factors to affect BEPS. The ‘contractual term/s’ factor has a key role in the comparability analysis, as also the ‘controlling risk’ factor.

As we have also seen from the above and will also be seeing in the subsequent chapter that though there is more or less a broad similarity in where and when to adopt a particular method but the Indian Transfer Pricing Regulations are strangely
silent in *how* to apply them. Even the OECD Guidelines don’t provide much assistance regarding the same.

The chapter furthermore highlights the dearth of application of the canon of a ‘*commercial rationality test*’ which as per the researcher should be applied at every preceding level of application of transfer pricing methods.