CHAPTER IV

CHAPTER 4:

ALP and MOST APPROPRIATE METHOD:

COMPARABLES and ADJUSTMENTS –

PSM and TNMM

The previous chapter detailed out the Traditional Transaction Methods (CUP, RPM and CPM). This chapter deals with the Transactional Profit Methods – Profit Split Method (PSM) and Transactional Net Margin Method (TNMM), which are applicable where complex nature of transactions exist and/or availability of comparable transactions are missing. The PSM method uses comparison of net profits earned by the associated enterprises, whereas TNMM compares net profit margins by computing costs in goods, sales affected and assets employed to reach ALP.

As discussed in the previous chapter, 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.

4.1 PROFIT SPLIT METHOD (PSM)

This method\(^1\) is one of the two transactional profit methods; wherein the combined profits of the enterprises in question are weighed against their relative contributions, i.e. – the determination of combined profit or loss vis-à-vis the relative value of contribution of the tested party to the afore-deduced combined profit. The ALP is then arrived at, by dividing the consolidated profit of the associated enterprises.

\(^1\) Rule 10B(1)(d).
4.1.1 Mode of splitting and allocating profits under this method

The profit and expenditure allocation under the profit split method can be done under two sub-methods, i.e. comparable profit split and a residual profit split method; The former method is applied, by combining the operating profit of all the concerned assessees/controlled enterprises on one hand and on the other hand combining the operating profit of the uncontrolled assessees whose transactions and activities are similar in nature. The proportionate percentage of operating profit derived from the individual uncontrolled enterprise is then used to allocate the profit to the relevant business activity of the assessees/controlled enterprises.

And under the latter method the combined operating profit from the relevant business transaction/activity is allocated between the controlled assessees after deducting routine contributions proportionately between them.²

The analysis for its application and consequential estimation for the division of profits, may be done under the two following main heads – a) contribution analysis and b) residual analysis. The two in certain given circumstances can even be used together complementing each other and are not necessarily mutually exclusive.³

4.1.2 Contribution Analysis

Under this mode the relative value of functions performed⁴ by each individual associated enterprise is taken into account for allocating the combined profits in relation to the controlled transaction. The division of profits under this analysis by making a reasonable approximation of the same which compatible independent enterprises would have expected to gain from such a comparable transactions.⁵ It must be borne in mind that in all such cases the profit that is being divided is always the operating profit and not the gross profit.

² See also in this regard Para 3.9 of the OECD Guidelines 2010, supra, n. 67.
⁴ FAR Analysis.
The estimation of such operating profit is made by taking into account each individual enterprise’s contribution in relation to providing services, incurring expenses and importantly any capital invested by the enterprise, and then comparing it with other external compatible data available.6

4.1.3 Residual Analysis

This analysis involves a proportionate allocation of profit, keeping in mind the basic return and then dividing the rest of the profit remaining between the enterprises. The mode involves a two-step process –

First allocation has to be made of those profits which are linked to providing this return to the independent Enterprises in comparable uncontrolled transaction.

Then second, the leftover/residual profits are thereafter divided among the tested parties, again based upon their relative value of their individual contribution to the unique/intangible assets (those assets which were not taken into account in the 1st step).

4.1.4 Usual Application

As per Rule 10B(1)(d) of the Income Tax Act, the method is most suitable for determining the ALP in the transactions “involving transfer of unique intangibles or multiple interrelated transactions that cannot be evaluated separately”7.

Unlike the CUP method the main application of PSM is in cases where it is extremely difficult to identify and pinpoint comparable transactions between independent enterprises since the reliance on close compatible transactions are at a minimal under this method. It is usually applied by simply allocating the profits based upon functions performed between the associated enterprises themselves. The application of this method is explained by the following Figure 4.1.

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6 Some of the economic tools for objective quantification of such contribution of the involved enterprise includes – bargaining through the approach, compensation approach, so we approach and capital investment approach.

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Minus functional / assets returns to each party based on market benchmarks

Residual profit split, based on each party's ownership of non-routine intangible assets, for example network reach efficiency, etc.

Figure 4.1
Source: Deloitte

The application of this method extends to intangible property employed in the controlled transactions in regard to analyzing the respective contributions by the enterprises. The traditional application of this method is done in the intangible property sector like that of pharmaceuticals, telecommunications or any such similar industry where the transactions heavily rely upon an intangible.

4.1.5 Comparability And adjustments under PSM Method

While using this method sometimes difficulty arises in trying to arrive at the ‘relative value of the contribution by the individual AE’. In such cases while effectuating the comparability analysis reliance is placed qua ‘about the nature and extent of each party's individual contribution and thereafter a percentage is assigned based upon the relative comparison and external data’.

Comparability under this method is determined vide 2 sub-methods.

4.1.5.1 Comparable Profit Split Method

As the name suggests under this method the division of operating profits of both the controlled and uncontrolled enterprises is done on a comparative scale assuming the enterprises are involved in similar business activities and/or under same or similar market conditions. The conditions also highlight the importance of considering the similarity in the terms of contract amongst the enterprises, based on which the allocation of function and risks can be made while conducting the comparability analysis under this method.

This method makes an important assumption that the operating profits of the controlled and uncontrolled enterprises will not differ.

4.1.5.2 Residual Profit Split Method

The difference between residual and comparable PSM is that the residual PSM is more dependent upon ‘market benchmarks of profitability’, for conducting the comparability analysis. This sub-method also makes assumptions of making profitability on the allocation of costs, income and assets, apart from assuming the accounting consistency.

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11 ibid, at p. 218
4.1.6 CASES –

*ITO v. Net Freight (India) P. Ltd.*\(^{12}\)

The assessee used residual PSM for benchmarking its transaction wherein it provided logistics services amongst other fellow subsidiaries, by providing each other as exclusive agents in relation to the shipments; and allocated 50% profit sharing arrangement under this method.

The Delhi Tribunal while upholding the PSM as MAM and rejecting the use of TNMM by the TPO, observed that the correct use of PSM method would be by splitting the profit in the relative contribution of the involved associated enterprises, based on a scientific reliable external market data and not on an ad hoc basis as done by the assessee.

**Outcome - PSM adopted as MAM for the international transaction of providing of logistics services to AEs.**

*Hyper Quality India P. Ltd. v. ACIT*\(^ {14}\)

Another Delhi Tribunal decision revolved around use of the PSM method as the most appropriate method (MAM). The assessee was a captive service provider and was involved in the business of rendering back office support services to its Associated enterprises located in the United States of America.\(^ {14}\)

The Tribunal held that the instant case was not a case of shifting of profits since the associated enterprise located in USA was sustaining continuous losses, whereas the assessee was earning profits in India. The Tribunal rejected TPO’s application of the TNMM method sans any justification provided by the TPO and accepted the application of the PSM method by the assessee given the absence of any objective objections made against the same by the TPO.

**Outcome - PSM adopted as MAM for the international transaction of rendering back office support services by a captive service provider to its AEs.**

\(^{12}\) (2014) 30 ITR (Trib.) 441 (Del).

\(^{13}\) (2014) 32 ITR (Trib.) 37 (Del).

Global One India P. Ltd. v. ACIT\(^{15}\)

The Delhi Tribunal dealt herein with a Telecommunication case while upholding the adoption of the residual PSM method by the assessee in light of the nature of the complex transaction, involving multiple associated enterprises each making their respective relative contributions, performing functions, incurring risks and using assets. Each individual enterprise deployed their manpower and had ownership of assets at different locations, which contributed to the global network. The entire transaction involved functions performed by more than one enterprise, which made the operations integrated and generated revenue.

The use of the TNMM method by the TPO was rejected and the tribunal affirmed his Order following the OECD Transfer Pricing Guidelines and the United Nations Transfer Pricing Manual, which prescribe the use of the PSM method for allocation of residuary profits in proportion to the relative contribution made by the associated enterprises. The tribunal held that, “When one transaction requires deployment of assets and functions of different entities located in different geographical locations in order to ultimately deliver services and when such combined efforts generate revenues, most appropriate method for determining arm’s length price in such a case would be ‘Profit Split Method (PSM).’”\(^{16}\)

The tribunal's ruling is in consonance with both the OECD Guidelines\(^{17}\) for multinational enterprises and tax administration as per Para 2.121, Chapter 2 on transfer pricing methods, as well as the United Nations - Practical Manual on Transfer Pricing for Developing Countries, para 6.3.13.3, Chapter VI - Transfer Pricing Methods, both of which state that the Profit Split Method is most applicable to transfer pricing issues involving intangible property, trading activities or financial services, where transactions and enterprises are located in many different geographical locations.

Outcome - PSM adopted as MAM for the international transaction of rendering back office support services by a captive service provider to its AEs and is the MAM where transactions are spread across multiple jurisdictions and combined efforts generate revenues.

\(^{15}\) (2014) 31 ITR (Trib.) 722 (Del).
\(^{16}\) ibid, at para 19.
\(^{17}\) OECD Guidelines 2010, supra, n. 67, at para 2.121.
4.2 TRANSACTIONAL NET MARGIN METHOD (TNMM)

One of the most liberally applied methods in India, by both the assessee and the Income Tax Department is the Transactional Net Margin Method (TNMM). Initially though this method was introduced by the OECD in 1979\(^\text{18}\) only as a last resort in an attempt to bridge the differences between the United States and European countries over the adoption of the best method rule.

TNMM is a method where the focus is on the net profit margin against an appropriate COMMON BASE, like costs incurred, sales undertaken or assets employed. By using this method, the arm's-length price is determined by comparing this net profit margin/s earned by the related and unrelated parties in the controlled and uncontrolled transactions respectively.

TNMM compares\(^\text{19}\) the NET PROFIT of a company involved in a *non-arm's length transaction (uncontrolled transaction)* with an appropriate base-line of *Sales, Costs and Assets Employed* and in *similar transactions* with Adjustments made based on the *actual circumstance of the transaction (IT with an AE)*. The uniqueness of this method lies in its objective measurement of profitability thorough the use Profit Level Indicators (PLI) indicators that measure the profits as a percentage of a given base to achieve the respective net margins required for comparability.

The operating profit relative to the appropriate base of the ‘tested party’ is compared with the operating profit of the unrelated party in a comparable uncontrolled transaction. The comparison of the net margins is done through ratios which measure the profits with reference to a percentage of a given base.\(^\text{20}\) Much alike the CPM and RPM methods the net margin herein is also calculated based upon an appropriate base, i.e., costs, sales, or assets.

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\(^{19}\) Clause (e) of Sub-Rule (1) of Rule 10B of the Income Tax Act, provides for this method.

\(^{20}\) Discussed in detail below under the heading ‘PLI Indicators’.
Figure 4.2
Source: PwC November 2013 Presentation, Slide 8

Figure 4.3
(Explanation through annotations by the Researcher)
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4.2.1 Usual Application

Earlier TNMM was used as a residuary method where CUP, RPM or CPM could not be applied. Nowadays its one of the most common methods used especially where the available data for the comparable transactions is unavailable or unreliable. Wahi\(^{21}\) rightly points out the reasons for preference of the TNMM method as compared to other methods, given its high tolerance limit to the functional differences in comparable transactions – since net margins are more tolerant than gross margins. Since the object of comparison in other traditional transactional methods\(^ {22}\) is PRICE, for which data may not be easily available and/or in other cases may not be reliable, TNMM is the automatic choice.

The method is more applicable to cases where at least one of the involved parties to the transaction is one either having no intangible asset or bearing minimum risk. This method is more advantageous in instances where one of the parties involved in the controlled transaction is complex, having multifarious interrelated activities.

4.2.2 Comparability and Adjustments under TNMM Method

By carrying out comparability under the TNM method the determination of net profit margin is minimally affected with any product differences, unlike the three traditional transaction methods, CUP, RPM and CPM. Functional similarity is the key to reduce the number of adjustments while applying this method. At the very outset it must be pointed out that the comparative data used should be in relation to the most closely identifiable business activity qua the controlled and uncontrolled transactions.

Needless to add, as is prevalent in all the other methods, the carrying out of FAR\(^ {23}\) analysis precedes the application of this method. The importance of the FAR analysis is writ large given its assistance in determining the economic value as added by each enterprise involved in the transactions to ultimately determine the comparability and


\(^{22}\) CUP, RPM and CPM.

\(^{23}\) Functions performed, assets employed and risks assumed.
adjustments\textsuperscript{24} requirement.\textsuperscript{25} No gain to state that similar to all other methods, the TNMM also uses both internal and external comparables, keeping in mind the differences arising from their usage, which may lead to adjustments in order to negate any differential effect on profitability. Since this method uses the net profit margin indicator the OECD guidelines have observed it to be sensitive to differences in capacity utilization given the effect of indirect fixed cost like, manufacturing cost or distribution costs.\textsuperscript{26}

Apart from the FAR Analysis, due consideration needs to be given to the –

a. Unique characteristics of the property or services, if any;

b. characteristics of the enterprise

c. contractual terms

d. prevailing market conditions

By taking these aforementioned factors into consideration, comparison should be made, qua the controlled and uncontrolled transactions, between ‘net margins derived from the operations of unrelated parties with similar operations carried out by associated enterprises’\textsuperscript{27}.

The comparisons of net margins while applying this method are usually carried out either at the ENTITY LEVEL\textsuperscript{28} or at TRANSACTIONAL LEVEL\textsuperscript{29}. Comparison at entity level means comparing the net margins of the whole controlled and uncontrolled enterprise as one unit, instead of comparing the net margins of the controlled and uncontrolled enterprise only to the extent of the relevant transaction involved, which is done at the transactional level.

The juridical opinion suggest towards the application of the method at the transactional level and not the entity level. The Mumbai Tribunal in

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\textsuperscript{24} See case of Egain Communication P. Ltd., 188 TTJ 354
\textsuperscript{25} Wahi, 5th ed., 2013, supra, n. 12, p. 183.
\textsuperscript{26} As provided in Deloitte, 2015, 4th ed., supra, n. 21, p. 221.
\textsuperscript{27} Wahi, 5th ed., 2013, supra, n. 12, p. 182.
\textsuperscript{28} With appropriate adjustments made.
\textsuperscript{29} Provided that reliable comparable data is available.
DCIT v. Starlite\textsuperscript{30} went to the extent of stating that the Act itself does not provide for TNMM to be applied to compare net margins at enterprise level, but only at the transactional level.\textsuperscript{31} In fact the Delhi Tribunal in the case of Global Vantage P. Ltd. v. DCIT\textsuperscript{32} also observed that since the modus operandi of the method itself suggests evaluation of profitability of transactions individually rather than that of the enterprise as a whole, comparison of net margins to be undertaken at the transactional level and not the enterprise level. At best the examination in relation to the comparability at transactional level could be extended to a class of transactions that may be closely interlinked.

The Tribunal reiterated its stand in the case of UCB India P. ltd. v. ACIT\textsuperscript{33}, holding that the method should be applied at a transactional level by considering and comparing distinct activities individually, instead of comparing it after aggregating the same. Aggregation automatically entails the consequential requirement of more appropriate adjustments to be made by conducting the comparative analysis; adjustments to the net profit margins for any material differences affecting the net margins in open market conditions need to be made herein. An example of such aggregation could be seen in one of the tribunal decisions rendered in 2011\textsuperscript{34}, where the assessee while applying the TNMM method in transactions relating to affecting sales to its subsidiaries. The assessee chose to carry out the comparability analysis at entity level instead of transaction level, and in doing so aggregated all the transactions. Though the Tribunal ultimately held that the CUP method was the most appropriate method in light of the available and reliable CUP data available; it again observed the preference of transactional level analysis instead of entity level.\textsuperscript{35}

\section*{4.2.3 Profit level Indicators (PLI)}

Once the comparables to be used are sorted out and the FAR analysis reveals the adjustments to be made, the next most important step in the application of TNMM

\textsuperscript{30} 40 SOT 421 (2010) Mum AT.
\textsuperscript{31} See also, DCIT v. S Namenda (2010) 41 SOT 1 Mum Trib.
\textsuperscript{32} (2010) 37 SOT 1.
\textsuperscript{33} 121 ITD 131 Mum.
\textsuperscript{34} Dishman Pharmaceuticals and Chemicals Ltd v. DCIT, ITA No. 154 and 587 of 2007 Ahmedabad.
\textsuperscript{35} Also see in this regard decision of the Mumbai Tribunal in the case of UCB India P. Ltd. v. ACIT, ITA No. 428 and 429 of 2007 - Discussed in detail below under the heading ‘Case Laws’.
method for determination of the arm's-length price is choosing the measure of profitability, – or as commonly called in the TP jargon – a profit level indicator (PLI). The PLI helps in determining the relationship between the net profit/operating profits and any of the appropriate bases of costs, sales or assets (CSA).\(^\text{36}\)

The nature of transactions and the class of business are the basic criteria upon which the choice of the PLI indicator is based on. The TNMM method typically uses some form of ratio analysis for ‘measuring profits as a percentage of a given base’\(^\text{37}\). The ratios/indicators most commonly used are return on costs, sales, and assets respectively. Few definitions assumes significance while using the PLI ratios to apply the TNMM method.

**Return on costs (ROC)**

This ratio measures/indicates the return on total cost\(^\text{38}\). The costs normally include the operating expenses including the COGS (cost of goods sold). This is mostly applied in cases for provision of rendering services.

**Return on Sales (ROS)**

This involves using of operating profit by sales ratio while conducting the comparability analysis.

**Return on Assets (ROA)**

This ratio measures/indicates the return on assets employed\(^\text{39}\). This method is usually applied to manufacturing companies, and is not advisable in cases of transactions involving entities carrying on distribution activities. Since it directly involves the assessment of return on assets, the characteristic, condition of assets can cause differences, which may need to be adjusted at a later stage. Given that the focus is entirely on assets while using this ratio it is not often used in transactions involving intangible property.\(^\text{40}\)

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\(^{38}\) Or full cost + mark up, as the case maybe.

\(^{39}\) Assets employed.

\(^{40}\) The assessee and/or the income tax department, may also use some of the other ratios – 1. Berry ratio, 2. Return on capital employed, 3. operating profit to employees, and 4. Return on value added expenses.
4.2.4 CASES

In one of the cases that came before the Delhi Income Tax Appellate Tribunal in relation to the applicability of the TNMM method and the significance of the FAR Analysis was in the case of Ranbaxy Laboratories Ltd. The tested party/Assessee had transactions involving supply of goods and services to its AEs.

TNMM was adopted as MAM since it was the best method to opt from while choosing comparables from different countries, with the transaction/s involving supply to more than one different geographical jurisdictions. The PLI chosen was OP/sales, and it was observed by the Tribunal that conducting a FAR analysis while applying the TNMM method becomes automatic.

**Outcome - TNMM as MAM for international transaction of supply of goods and services to AEs located in different geographical locations.**

4.3 INTER-SE PREFERENCE OF METHODS

Having gone through the methods and their adoption along with the cases highlighting the international transactions where these methods are applicable, it is now important to appreciate the *inter-se preference* of methods while being made applicable to similar international transactions. This assumes significance since any sort of divergence between the methods in their application may lead to uncertainty. The uncertainty stems from the fact that in huge multinational groups (MNCs) having associated enterprises in different jurisdictions and having international transactions worldwide, cannot possibly afford to apply two methods (which may equally be applicable) with the same international transaction between the two countries.

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Few instances of the *inter-se preference* of methods as applied by the Indian courts while interpreting the Indian Transfer Pricing Regulation are provided herein.

### 4.3.1 TNMM v. CUP

One of the most recurring disputes is between the application of the direct CUP method concentrating on the transactions VERSUS the indirect profit assessing TNMM method concentrating on operating margin of profits.

One of the important cases highlighting this conundrum is of *UCB India P. Ltd. v. ACIT, (2009) 121 ITD 131 (Mum.)*.

- Facts of the case were that the assessee was engaged in the business of manufacture and marketing of prescription drugs and was routinely purchasing raw material from its parent Belgium company, the AE. The raw material in question was API (Active Pharmaceutical Ingredients).
- The assessee simply applied the TNMM method by comparing the operating profit margins earned from the whole transaction as one as against those margins earned by the comparable Enterprises.
- The TPO rejected this and applied the CUP method by using the average API raw material price being purchased by three other comparable competitive Enterprises.

The tribunal rejected the stand of the TPO and held that merely because CUP method is a direct method its application does not automatically ensue. The judgment held “*that even a minor change in the properties of the product, circumstances of trade billing period, amount of credit, etc. may have a significant effect on the price.***

Though Product comparability is a key criteria but pricing of a product itself is a very subjective exercise and can differ at different marketplaces, therefore comparing profit margins of the enterprises located in different jurisdictions would be the most appropriate method.”

Upheld TPO’s application of TNMM method since similar comparables for the items/products imported from both AEs and non-AEs, were not available.

Welspun Zucchi Textiles Ltd. v. ACIT

The tribunal rejected the application of CUP method due to the difference in geographical location of the markets, holding that the non-AE, i.e. Walmart was based in the USA being a bigger market as compared to the AE’s market, i.e Italy. In the absence of any precise comparables and availability of exact data in order to compare the prices of similar products supplied to both the AEs and non-AE’s, TNMM (instead of CUP) was held to be the most appropriate method.

In the aforementioned cases, TNMM is preferred over CUP, since TNMM assumes preference against CUP in cases where the products supplied is unique and no other instances of comparable transactions are available.

4.3.2 CUP v. RPM

“Suitability of the RPM method depends upon similarity of characteristics having a bearing on the profit margin than the similarity of products”

Gharda Chemicals Ltd. v DCIT

In a classic face-off between the applicability of CUP v. RPM method, the Mumbai Tribunal held that the basic difference between the two methods is that RPM should be applied where the property has been purchased and then re(sold) by the tested party/Assessee. In this instant case assessee had sold a product to its wholly owned subsidiary in the USA and drawn comparable third party references from Chinese companies selling the same product to the US. In such a case, the Tribunal held that since only the transaction of selling (no reselling) has taken place by both the assessee in the controlled transaction as also in the comparable uncontrolled transaction, thus RPM could not be applied here and CUP method should be applied.

42 (2013) 30 taxmann.com 251 (Mum-Trib.)
44 (2010) 35 SOT 406 (Mum.)
4.3.3 RPM v. TNMM

TNMM will assume preference over RPM in cases where the AE do not undertake any distributor functions. See *ITO v. L’oreal India P. Ltd* 45

4.3.4 RPM v. CPM

Both RPM and CPM can be used to examine the same transaction between a manufacturer and a distributor – but will eventually depend upon the functional similarity and comparability. That having been said RPM assumes precedence in transactions involving intangible goods; For eg. in case of a fee/royalty for technical services using intangible assets can be determined more closely and easily by using the RPM method, since it is ‘exceedingly difficult to determine costs involved in developing technological know-how’. 47

The difference between the two methods can be seen from the fact that CPM lays emphasis on the gross margin earned by the supplier, whereas RPM puts emphasis on the gross margin earned by the distributor on resale. The former is suitable for transactions involving supply of finished or semi-finished goods by the provider of services, whereas the latter method can be applied to transactions involving resale of products procured from AE/s, without any significant value addition.

4.3.5 CPM v. TNMM

CPM is considered MAM in comparison to TNMM in cases where there is not much substantial difference in the functions performed or the risks undertaken of similar activities carried on by the entities, and importantly their verifiable ‘costs data’ is available, since the reliability of data is assured. 48

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45 supra, n. 124.
46 and therefore difficult to adopt cost based CPM Method.
Unlike TNMM, in the CPM method there is no necessity of stating the books and records and allocating costs for all enterprises involved in the transactions; which may be extremely burdensome in case one of the parties involved in the controlled transaction is complex, having multifarious interrelated activities.

4.3.6 TNMM (profit based) V. other methods – CUP, RPM and CPM (direct method)

Mattel Toys P. Ltd v. DCIT\(^{49}\)

The Tribunal observed that TNMM required a lot of adjustments to finally determine the actual profit margin, therefore in cases where the ALP can be determined by the application of any other direct methods like CUP, RPM or CPM, then in such cases these direct methods will gain precedence over the application of TNMM. It held –

"On the other hand, under the TNMM, the ALP is determined by comparing the operating profit related to an appropriate base i.e., cost or sale or assets of the "tested party" with the operating profit of an uncontrolled party engaged in comparable transactions. It requires a lot of adjustments to derive the actual operating profit. If the ALP of any transaction can be determined by applying any of the direct methods like CUP, RPM, CPM then they should be given preference, and once these traditional methods have been rendered inapplicable, then only TNMM should be resorted to. On the facts of the assessee's case, the assessee being a distributor who was purchasing the goods from its A.E. and reselling them to independent parties/unrelated parties, resale price method would be the most appropriate method for determining the ALP of the transactions between the assessee and the A.E."\(^{50}\)

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\(^{49}\) (2014) 30 ITR (Trib) 283 (Mum.)  
\(^{50}\) *ibid*, Para 40
4.4 CONCLUSION

This chapter elucidates upon the two remaining transfer pricing methods – Transactional Profit Methods which are applicable where complex nature of transactions exist and/or availability of comparable transactions are missing.

Importantly the chapter highlights that the old OECD guidelines gave precedence to the traditional transaction methods over transactional profit methods but this distinction was done away in in the new 2010 OECD guidelines. In fact as established in this chapter, Para 2.4 of the OECD revised Guidelines provides for instances where transactional profit methods may be found to be more appropriate and reliable as compared to traditional transaction methods; since 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.

Chapter 3 and Chapter 4 also provide that, 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.

The inter-se preference between methods as is evident from the cases highlighted under the two chapters (3 and 4) show the uncertainty that may arise in applying these methods by the MNCs having associated enterprises in different jurisdictions and having international transactions worldwide, who cannot possibly afford to apply two methods (one preferred by one country and another preferred by the other country) for the same international transaction between the two countries.

51 See Para 2.4 of the OECD revised Guidelines 2010, supra, n. 67.