Transfer Pricing Methods

Transactional

Net Margin

Method

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Transfer Pricing Methods

Agenda

- Introduction
- Transactional Net Margin Method 'TNMM'
- Comparable Profits Method 'CPM'

Transfer Pricing Methods

Most Appropriate Method

- OECD advocates the use of Traditional transaction methods (CUP, RPM and CPM) over Transactional profit methods (PSM and TNMM) [Chapter III,3.49]
- Flexibility granted to taxpayer for selection of Most Appropriate Method
- No preference for any particular method under Indian transfer pricing law

Transfer Pricing Methods

Selection of Most Appropriate Method [Rule 10C(2)]

- Factors determining Most Appropriate Method
  - nature and class of international transaction
  - class of associated enterprises and functions performed
  - availability and reliability of data
  - degree of comparability
  - extent and reliability of adjustments
  - nature, extent and reliability of assumptions

Transfer Pricing Methods

- Traditional transaction methods
  - Comparable Uncontrolled Price method
  - Resale Price method (RPM)
  - Cost Plus method (CPM)
- Transaction profit methods
  - Profit Split Method (PSM)
  - Transactional Net Margin Method (TNMM)
- Any other method that may be prescribed by the CBDT

Transactional Profit Methods – OECD Discussion Draft

- Review of Transactional Profit methods
  - Status as method of last resort
  - Proposed amendments to TP Guidelines
- Use of more than one Method
  - Use of a transactional profit method in conjunction with a traditional transaction method
  - Use of a sanity check to test the plausibility of the outcome of a primary method

Transfer Pricing Methods

TNMM

- Identify net profit margin realized by the enterprise from an international transaction **with regard to an appropriate base**
- Identify net profit margin from a comparable uncontrolled transaction or a number of such transactions having regard to the same base
- Adjust for differences that could affect net profit in the open market
- Adjusted net profit used for establishing Arm's Length Price

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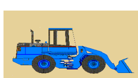
Transfer Pricing Methods

Application of TNMM

Independent Distributor

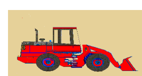


A

	Rs.
Turnover	75,000
COGS	41,250
GP	33,750
GP/Sales	45%
Admn. & Dist.	30,000
OP	3,750

AE Distributor

B



	Rs.
Turnover	100,000
TP	60,000
GP	40,000
GP/Sales	40%
Admn. & Dist.	35,000
OP	5,000

TNMM
(OP/Sales)
= 5%

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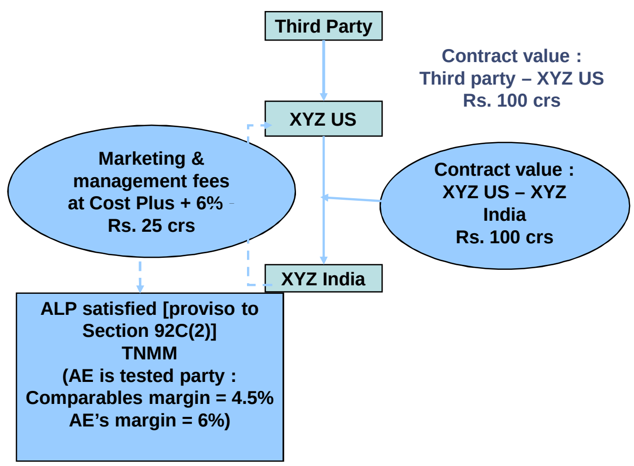
Application of TNMM

- Typical transactions where the TNMM may be used :
  - Provision of services
  - Distribution of finished products where RPM cannot be adequately applied or in case of a full-fledged distributor
  - Transfer of semi finished goods

- Inapplicability of all other methods – residuary method

Application of TNMM

XYZ India - XYZ US



Strengths and Weakness of TNMM

- Strengths:
  - less affected by transactional differences
  - more tolerant to some functional differences
  - classification of expenses in the gross margin frequently makes it difficult to evaluate the comparability of gross margins; the use of net margins may avoid the problem
  - Being a one-sided method, it is required to examine the financial indicator of the tested party alone
- Weaknesses:
  - net margin can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect
  - these aspects may make accurate and reliable determinations of arm's length net margins difficult

Some Experiences……

- Aggregation of transactions
- Loss situations
- Choice of PLI
- Startup companies, Business Strategies
- Adjustment to net profit for calculating operating profit
- Percentage of AE transaction to total revenue/costs
- Preliminary/Pre-operative expenses
- Pass through costs

Transfer Pricing Methods

Case Laws

- Development Consultants Pvt Ltd – Tested Party and choice of method
- Star India – Distinct and separate activities to be considered individually
- Schefeneckar Motherson – Cash Profit Margin as PLI
- Morgan Stanley – Use of TNMM as most appropriate method
- UCB India – Inappropriate aggregation of transactions - TNMM analysis at transaction level
- Honeywell Automation - Only those items of income/expenses having nexus with profit/loss should be considered for comparability purposes
- Skoda Auto – Economic adjustments to be made to results of tested party and comparables for differences in functional profiles

Transfer Pricing Methods

Summary of Methods

Methods	Comparability Requirements	Approach	Remarks
CUP	Very High	Prices are benchmarked	Very difficult to apply as very high degree of comparability required
RPM	High	Gross Profit margins are benchmarked	Difficult to apply as high degree of comparability required
CPM	High	Gross Profit margins are benchmarked	Difficult to apply as high degree of comparability required
PSM	Medium	Operating Profit margins are benchmarked	Complex Method, sparingly used
TNMM	Medium	Operating Profit margins are benchmarked	**Most commonly used method**

Transfer Pricing Methods

Choice of Profit Level Indicators (PLIs)

- Each method, with the exception of the CUP method, examines a profit level indicator (PLI) relevant to the method of analysis
- Specified financial ratio of the tested party is compared to the results of independent, functionally comparable companies

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Profit Level Indicator (PLI) and Methods

GP/Sales = GM

RPM

GP/COP

CPM

OP/Sales
OP/TC
Berry Ratio = GP/Opex
OP/VAE {Berry Ratio = 1+ (OP/VAE)}
OP/CE or OP/Assets
Cash Profit Margin

TNMM

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Transfer Pricing Methods

Choice of Profit Level Indicators (PLIs)

Method	PLI	Formulae	Typically used for
RPM	Gross margin	Gross Profit/Sales	Distributor
Cost Plus	Gross cost plus	Gross Profit/COGS	Manufacturer/ Service provider
Full Cost Plus/ TNMM	Net/Full cost plus (Return on total costs)	Operating profit/Total costs (Total costs = COGS + OPEX)	Manufacturer/ Service provider
TNMM/ PSM	Operating margin	Operating Profit/Net sales or net turnover	Manufacturer/ Distributor/Service provider
TNMM/ PSM	ROA	Operating Profit/Operating assets	Manufacturer/ Distributor/Service provider
TNMM/ PSM	ROCE	Operating Profit/Total assets – Current Liabilities	Manufacturer/ Distributor/Service Provider

Tangible Property Methods

Comparable Profits Method

- Reg. § 1.482-3 read with Reg. § 1.482-5 - Assigns an arm's length return for the controlled transfer of tangible property based on profit level indicators ("PLIs") of uncontrolled parties performing activities similar to those of the controlled tested party.
- Looks at the party that is the least complex in terms of functions, risks, and intangibles owned ("tested party").
- The Comparable Profits Method is most commonly used with PLIs that are based on operating profit.

Comparable Profits Method

Specified PLIs

- Return on assets (return on capital employed);
- Operating margin;
- Berry ratio (GP/OE); or

Other appropriate financial ratios where the denominator does not reflect controlled transactions.

- Cannot use operating margin if selling to related parties (controlled sales in denominator).
- Cannot use GP/COGS or OI/TC if buying from related parties (controlled costs in denominator).

Comparable Profits Method

Adjustments required if material, identifiable differences exist between the unrelated and related transactions.

- One type of adjustment is an “asset intensity,” “balance sheet,” or “working capital” adjustment. This adjustment is performed when a CPM is used, either by itself or as part of another method such as a residual profit split. Adjustments are for differences in A/R, A/P, and inventory.
- Other adjustments include PP&E adjustments and SG&A adjustments.

The CPM is the most commonly utilized method to test and document the arm’s length nature of a tangible property intercompany transaction.

Comparable Profits Method

- Encourages segmentation of financials.
- Discourages use of industry average.
- Discourages analyzing company-wide profitability when there is a distinct differences between lines of business.
- Proper application of CPM under U.S. regulations is consistent with Transactional Net Margin Method (TNMM) under OECD Guidelines (assumes comparable transactions are comparables' only transactions).

Comparable Profits Method

- The choice of tested party can reflect a choice about how to allocate risk.
- Assigning a party only a routine return implies viewing that party as a mere service provider; a profit split, in contrast, implies viewing that party as a risk-taking entrepreneur or joint venture partner.
- Normally, the parties' own definition of their relationship should be accepted unless it is inconsistent with their conduct and the economic substance of the transactions.

Tangible Property Methods

Comparable Profits Method

Consider a manufacturer selling to a controlled distributor.

- Testing only the distributor (for example, using a CPM with an operating margin PLI) assigns the distributor a particular profit range.
- The distributor must then earn a profit within that range without regard to the system profit (i.e., the combined profit from manufacturing and distribution).

Tangible Property Methods

Comparable Profits Method

- Thus, the distributor might be guaranteed a certain positive profit level even when the manufacturer is sustaining substantial losses and the system profit is negative.
- This situation has been referred to as “profit creation” since it assigns profit to one party despite an overall loss.
- In particular cases this result may correctly reflect the relative risk; a routine distributor may be entitled to a profit when system profit is negative.
- In other cases, a routine distributor may be willing to bear losses for a short period of time if the industry is in a downturn.
- However, in some cases one could argue for a sharing of risk if both parties make value-added contributions to the transaction. This may call for the profit split approach in which both parties are tested.

Comparable Profits Method

Reg. § 1.482-5 – In general, determine whether pricing is arm's length indirectly, by seeing if a controlled taxpayer (the "tested party") earns profits similar to those earned by comparable companies that engage in similar business activities under similar circumstances

Comparability of functions more important than specific product

Compare profit level indicators ("PLIs"), such as operating margin, return on assets, etc.

Comparable Profits Method

- For intangibles, tested party would generally be licensee
- If licensee's profits are lower (higher) than those of comparable companies (after adjustment for royalties paid for the use of the intangible in question), the implication is that the licensee is paying too high (too low) a royalty for use of the intangible.
- What if comparables own or license valuable intangibles that increase profitability
  - Adjustments?

Comparable Profits Method

- Validate royalty rate by comparing post-royalty profit to operating profit earned by similar companies.
  - Choice of comparables
  - Choice of Profit Level Indicators

Comments: Comparable Profits Method

- Comparable Profits Method range can be wide
- “Comparable” companies typically own intangibles, whereas “tested party” is typically the licensee.
- Implicitly assumes all other internal prices are arm’s length (purchase of components, sale of finished products, service fees, etc.)

Temporary Regulations: Comparable Profits Method

- Treas. Reg. §1.482-9T(f)
- General principles set forth in Treas. Reg. §1.482-5 apply.
- Profit level indicator of operating profit to total services costs (markup on costs) is identified as potentially reliable basis for analysis of controlled services transactions.
- Examples provide guidance on when it may be appropriate to adjust the financial data of comparables and/or the tested party in order to account for stock-based compensation (under a grant date valuation).

THANK YOU