Comparable Uncontrolled Price Method – Overview and Practical Issues

Karishma R Phatarphekar &
Fatema Hunaid

Grant Thornton India

Workshop on Transfer Pricing, ICAI, Bangalore
03 November, 2009

Agenda

- Comparable Uncontrolled Price ("CUP") Method
  - Indian TP Regulations
  - OECD TP Guidelines
  - US TP Regulations
- Adjustments while applying CUP Method
- Judicial Precedents
- Industry Specific Issues

 2

CUP Method - Indian TP Regulations

CUP Method - Indian TP Regulations

Application of CUP Rule 10B(1)(a)

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

ii. such price is **adjusted to account for differences**, if any, between the international transaction and the comparable uncontrolled ***transactions*** ("CUT") or between ***enterprises*** entering into such transactions, which could materially affect the price in the open market.

iii. the adjusted price arrived at in clause (ii) is taken to be the arm's length price ("ALP") in respect of the property transferred or services provided in the international transaction.

No specific guidance on when this method is reliable except Rule 10C(2)

CUP Method - Indian TP Regulations Cont'd

Key points in law

- CUT can be **Internal** or **External**
- CUT(s) can be **Single or Multiple**
- In case of multiple, arithmetic mean can be used:
  - Proviso to section 92C(2)
  - Upheld by ITAT Bangalore
- Factors which have a material effect on the price to be adjusted:
  - Transaction level
  - Enterprise level
- Factors of comparability in Rule 10B(2) to be considered while selecting CUT
  - Characteristics of property / services & FAR
  - Contractual Terms
  - Conditions prevailing in the markets, location, laws in force, etc

CUP Method - Indian TP Regulations Cont'd

Internal CUP & External CUP

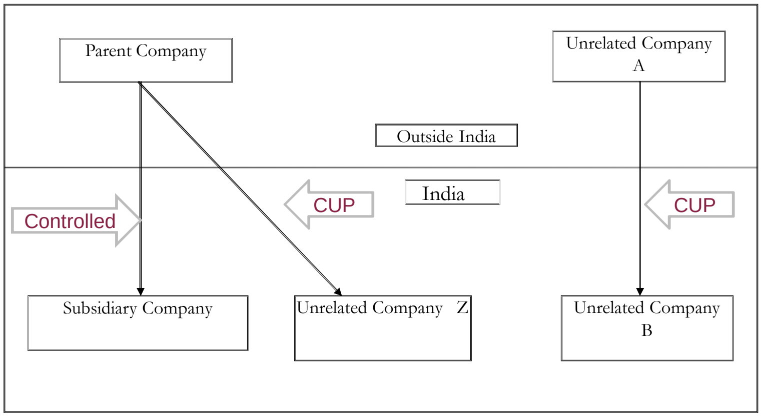
- **Internal CUP:**
  – Price paid or charged in a CUT *by the Taxpayer with a Independent Party*
- **External CUP:**
  – Price charged/paid in a CUT between *Independent Parties*

Internal CUP preferred over External CUP

CUP Method - Indian TP Regulations **Cont'd**

Internal CUP and External CUP

Internal CUP External CUP



CUP Method - Guidance under OECD TP Guidelines

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995 Edition

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

OECD

CUP Method - Guidance under OECD TP Guidelines

Definition & Mandate

- CUP method compares the **price charged** for the property or services transferred in a controlled transaction to the price charged for property or services transferred in a **comparable uncontrolled transaction** in **comparable circumstances**.
- Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the **most direct and reliable** way to apply the arm's length principle. Consequently, in such cases the **CUP Method is preferable over all other methods**.

CUP Method - Guidance under OECD TP Guidelines

Other Guidance

- CUP is a Traditional Transaction Method
- The most direct way to test controlled transactions
- OECD recognises the dearth of availability of CUP is recognised:
  - Minor difference in property / service may have a material impact on price
- Comparability adjustments are necessary
  - Adjustments can directly impact the reliability of the method

CUP Method - Guidance under OECD TP Guidelines

Example 1 – Effect of brand [Coffee Beans]

- An independent enterprise sells **unbranded Colombian coffee beans** of a similar type, quality, and quantity as those sold between two associated enterprises, assuming that the **controlled and uncontrolled transactions occur at about the same time, at the same stage in the production/distribution chain, and under similar conditions.**
- If the only available uncontrolled transaction involved **unbranded Brazilian coffee** beans, it would be appropriate to inquire whether the difference in the coffee beans has a material effect on the price. For example, it could be asked **whether the source of coffee beans commands a premium or requires a discount generally in the open market.** Such information may be obtainable from commodity markets or may be deduced from dealer prices.
- **If this difference does have a material effect on price, some adjustments would be appropriate**. If a reasonably accurate adjustment cannot be made, the reliability of the CUP Method would be reduced, and it might be necessary to combine the CUP method with other less direct methods, or to use such methods instead.

CUP Method - Guidance under OECD TP Guidelines

Example 2 – Effect of Volume

- Assume a taxpayer sells **1,000 tons of a product for $80 per ton** to an associated enterprise in its MNE group, and at the same time sells **500 tons of the same product for $100 per ton to an independent enterprise**.
- This case requires an evaluation of whether the **different volumes should result in an adjustment of the transfer price.** The relevant market should be researched by analysing transactions in similar products to determine typical volume discounts.

OECD releases a proposed revision of Chapters I-III of the Transfer Pricing Guidelines From 9-Sep-2009 to 9-Jan-2010

- This follows from the release in **May 2006 of a discussion draft on comparability issues** and in **January 2008 of a discussion draft on transactional profit methods**, and from discussions with commentators during a two-day consultation that was held in November 2008.
- Key Revisions:
  - Hierarchy of transfer pricing methods
  - **The OECD proposes removing exceptionality for profit based methods and replacing it with a standard whereby the selected transfer pricing method should be the "most appropriate method" to the circumstances of the case**
  - Guidance on the application of transactional profit methods developed
  - Three new Annexes were drafted, containing practical illustrations of issues in relation to the application of transactional profit methods and an example of a working capital adjustment to improve comparability

CUP Method - US TP Regulations

§ 1.482–3
Methods to determine
taxable income
in connection with
transfer of tangible property

CUP Method - US TP Regulations Cont'd

Comparability & Reliability Considerations

- **Similarity of products** generally will have the greatest effect on comparability under this method
- **Contractual terms or Economic Conditions** also very important and comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences.
- The results derived from applying the comparable uncontrolled price method generally will be the **most direct and reliable measure** of an arm's length price

CUP Method - US TP Regulations Cont'd

Factors relevant to CUP Method

- Quality of the product;
- Contractual terms, (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);
- Level of the market (i.e., wholesale, retail, etc.);
- Geographic market in which the transaction takes place;
- Date of the transaction;
- Intangible property associated with the sale;
- Foreign currency risks
- Alternatives realistically available to the buyer and seller.

CUP Method - US TP Regulations Cont'd

Indirect evidence of CUTs

- A comparable uncontrolled price may be derived from data from **public exchanges or quotation media**, but only if the following requirements are met:
  - The data is widely and routinely used in ordinary course of business in the industry to negotiate prices for uncontrolled sales.
  - The data is used to set prices in the controlled transaction in the same way that it is used by uncontrolled taxpayers in the industry; and
  - The amount charged in the controlled transaction is adjusted to reflect product and service variations.
  - *Use of data from public exchanges or quotation media may not be appropriate under extraordinary*

Aztec ITAT Ruling: Above principles are of universal application and there is no good reason why they should not be applied in transfer pricing determination in India.

CUP Method - US TP Regulations Cont'd

Example 1 – Effect of differing delivery terms

- ABC sells the same product to both controlled and uncontrolled distributors, except that the **controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. ABC's factory.**

- Differences in the **contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price**, and adjustments are made to the results of the uncontrolled transaction to account for such differences.

- Because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are **only minor contractual differences that have a definite and reasonably ascertainable effect on price**, **the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result.**

CUP Method - US TP Regulations Cont'd

Example 2 - Effect of trademark

- The facts are the same as in Example 1, except that ABC **affixes its valuable trademark to the property sold in the controlled transactions**, but does not affix its trademark to the property sold in the uncontrolled transactions.
- Under the facts of this case, the **effect on price of the trademark is material and cannot be reliably estimated.**
- Because there are **material product differences for which reliable adjustments cannot be made**, the comparable uncontrolled price method is unlikely to provide a reliable measure of the arm's length result.

CUP Method - US TP Regulations Cont'd

Example 3 - Minor product differences

- The facts are the same as in Example 1, except that ABC, which manufactures business machines, **makes minor modifications** to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales, but does not make these modifications in uncontrolled sales.
- If the **minor physical differences in the product have a material affect on prices, adjustments to account for these differences must be made to the results** of the uncontrolled transactions according to the provisions of section 1.482-1(d)(2), and such adjusted results maybe used as a measure of the arm's length result.

CUP Method - US TP Regulations Cont'd

Example 4 - Effect of geographic differences

- FM, a radio manufacturer, sells its radios to a controlled U.S. distributor, AM, that serves the West Coast of the United States. FM sells its radios to uncontrolled distributors to serve other regions in the United States.
- **The product in the controlled and uncontrolled transactions is the same**, and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same, other than the geographic differences. **If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made**, then the adjusted results of the uncontrolled sales may be used under the comparable uncontrolled price method to establish an arm's length range pursuant to section 1.482-1(e)(2)(iii)(A).
- If the effects of the **geographic differences would be material but cannot be reliably ascertained**, then the reliability of the results will be diminished. However, the **comparable uncontrolled price method may still provide the most reliable measure of an arm's length result**, pursuant to the best method rule of section 1.482-1(c), and, if so, an arm's length range may be established pursuant to section 1.482-1(e)(2)(iii)(B).

Judicial Precedents

- **Aztec Software**
- **MSS India**
- **Sun Chemicals BV**

Aztec Software and Technology vs ACIT
ITAT Bangalore [Special Bench]
July 2007

Aztec Software and Technology vs ACIT Cont'd

Facts

- Aztec India had a subsidiary company in US, Aztec US
- Aztec India paid Aztec US for onsite software development services & justified the ALP using the TNMM - Aztec US made 6.5% for FY 2001-02
- Aztec India paid Aztec US at cost plus 5% for the onsite software development services
- Aztec US functioned as a captive service provider insulated from most risks.
- There are 22 customers and billing rate varied from USD 55 to 210 per man hour. The average rate realized worked out to USD 79 per man hour.

Aztec Software and Technology vs ACIT Cont'd

TPO's Order

- ➢ TNMM rejected by TPO as (1) the net margin earned by **Aztec India from the transaction** has to be benchmarked and not **the margin earned by Aztec US from its entire business**; (2) Rule 10B(4) violated
- ➢ TPO sought details of onsite billing as the onsite revenue billed by Aztec India was less than onsite charges paid by it to Aztec US.
- ➢ TPO limited the ALP of charges paid by Aztec India to Aztec US to the charges received by Aztec India from its customers
- ➢ Cost plus model is inefficient and resulted in payment of USD 85 per hour as against USD 79 per hour received by Aztec India resulting in gross loss
- ➢ 'Aztec' is a valuable brand as the avg billing rate of USD 79 billed by Aztec India is more than the Average Industry Rate. On account of usage of 'Aztec' brand name a downward adjustment ought to be made to the billing rate

Aztec Software and Technology vs ACIT Cont'd

TPO's Order

➢ Adjustments to Internal CUP of USD 79 per hour

- Additional assets employed by Aztec India – esp brand name
- Additional functions performed by Aztec India
- Additional risks assumed by Aztec India
- No adjustments made u/r 10B(3)(i)read with 10B(1)(a)(ii) citing difficulty

➢ Adjustments to External CUP of USD 58-65 per hour [para 80]

- Industry average but representing independent entrepreneurs with full risk profile a downward adjustment required for a no-risk subcontractor
- Lower end of the range taken by the TPO citing the extra leverage being given to Aztec US

➢ Adjustment made:

- Aztec US' Billable Hours X [USD 85 – USD 58] = Rs. 9.06 crores

Aztec Software and Technology vs ACIT Cont'd

CIT(A) Ruling

- The thrust of the entire decision by the CIT(A) was on the applicability of Chap X and the procedure of reference by the AO to the TPO – rather than on determination of ALP
- Average based on a number of transactions is not tenable
- Man-hours do not include bench / wasted hours
- Rejected external CUP adopted by the TPO but did not comment on internal CUP detailed by the TPO or TNMM as used by the taxpayer

Aztec Software and Technology vs ACIT Cont'd

ITAT Ruling

- Relied on US Regs and OECD Guidelines
- No proper justification given by the TPO for rejecting TNMM
- CIT(A) erred in not examining the merits of the application of CUP nor tried to ascertain the correct comparables
- Order set aside for fresh determination

Unadjusted industry averages cannot be taken to represent arm's length conditions

Differences are not known and adjustments imaginary

ACIT vs MSS India (P) Ltd.
ITAT Pune
May 2009

ACIT vs MSS India (P) Ltd.

Facts

- India is engaged in manufacturing high quality component kits for OEMs - strap connectors
- International transactions:
  - Purchase of raw material – prices quoted on London Metal Exchange plus 2% to 6% mark-up – justified with Cost Plus Method
  - Export of manufactured goods – Cost Plus Method
  - ECB – CUP Method
- 84% of sales to AEs and balance 16% to third parties
- Cost Plus Method applied on internal comparables
- Also Net Loss of 7% is less than loss of comparables at 24%
- Subsequent years, TPO has accepted the transfer prices – on the same basis as above

ACIT vs MSS India (P) Ltd. Cont'd

TPO's order

- Rejected cost plus method as the basis of computation of gross profit margin is not clear
- Material consumption increased from 47% to 76% and this cost is not passed on to the AE
- Group TP Policy not provided
- Fresh search of comparables done and operating margin of 7.23% worked out
- Adjustment made by applying TNMM

ACIT vs MSS India (P) Ltd. Cont'd

CIT(A) Ruling

- Agreed with the taxpayer that the loss was due to under **utilization of capacity** and **increase in material costs**
- No motive for manipulating export prices
- Comparables selected by the TPO not 'comparable'

ACIT vs MSS India (P) Ltd. Cont'd

ITAT Ruling

- Vacated the CIT(A) ruling regarding non-applicability to cases eligible for income-tax exemption u/s 10A/10B
- Traditional transaction methods should have a preference over transactional profit methods subject to Rule 10C(2)
- **Purchases at London Metal Exchange plus mark-up accepted as CUP**
  - Freight and Insurance found >1%
  - 5% variation available under law
  - Mark-up of 6% including freight and insurance found reasonable and within the 5% variation
- Cost plus can be applied using internal comparables and there is no issue in computing gross profits

The true reason of ALP adjustments by TPO in respect of imports thus is not the prices being not at the arms length price but the loss having been incurred by the assessee in the relevant previous year

DDIT vs Sun Chemicals BV
ITAT Mumbai
June 2008

DDIT vs Sun Chemicals BV Cont'd

Facts

- Company is based in Netherlands
- It sold shares of a company from its AEs, listed on BSE and justified sale of shares based on BSE quotes applying CUP method
- CUP method was not applied for purchase of shares from AE as it contended that TP did not apply
- AO enquired the price of shares from the BSE on the date of purchase of shares by the Company – Rs. 73
- AO disallowed claim to DTAA and also disallowed the capital loss and computed a capital gain

DDIT vs Sun Chemicals BV Cont'd

Rulings

- **TPO's Order:**
  - TPO found the sale to be at arm's length
  - Purchase price was computed at Rs. 113 per share (originally purchased by assessee in GBP)
- **CIT(A)'s Ruling:**
  - Found DTAA is available to the assessee and capital gains therefore exempt in India
  - As regards purchase impliedly agreed with the AO that the purchase ought to be at ALP
- **ITAT's Ruling:**
  - Ruled that DTAA benefit is available to the assessee and therefore the other questions were not relevant

Applicability of CUP – Industry Specific Issues

IT / ITES Industry

- External CUPs generally not reliable:
  - Sources are generally annual reports or generic data compiled by research agencies from unreliable sources (including word of mouth)
  - Different Verticals command a different rate (Healthcare, Automotive etc)
  - Skill sets and levels of various personnel command different rates
  - Project durations
  - Timing of the projects – busy / slack season
- Internal CUPs generally more reliable and can be explored
- Unadjusted industry averages [like NASSCOM rates] cannot be applied
- TPOs applied until AY 2003-04 and later converged towards TNMM

Indenting function

- Generally work on the basis of a commission percentage across industries
- TNMM along with broad based comparables
- being rejected in such cases by TPO's and reliance placed on data gathered u/s 133(6) of the Act

Broking Services

Meaning

- The broker is an intermediary or negotiator in the contracting of any type of bargain, acting as an agent for parties who wish to buy or sell stocks, bonds, real or Personal Property, commodities, or services.

Issue

- CUP (Internal CUP) v/s TNMM

Contentions

- Volumes
- Risk profile of the client
- Types of trade
- Client relationship and Client Type
- Functional Differences
- Appropriate Adjustments (Marketing etc.)

Intra Group Guarantee and Intra Group Loans

Meaning

- A legally binding agreement under which the guarantor agrees to pay any or all of the amount due on a loan instrument in the event of nonpayment by the borrower.

Issue

- Use of CUP Method to determine the guarantee fee or the commission and rate of interest charged / received

Contentions

- Purpose for which the guarantee is given like Economic reasons, Shareholder Activity
- Functions and Risk Assumed
- Difficulty in finding comparable data in public domain
- LIBOR plus basis point
- Prime Lending Rate (PLR)
- Databases like Moody's, Loan connector can be used

CUP used is not reliable and applicable

Pharmaceutical Industry

Active Pharmaceutical Ingredients ("API")

- TPOs are seeking to apply prices extracted by them from Customs Databases in India to test import prices in controlled transactions
- Such comparability analysis is fraught with numerous flaws and the primary and material one among them being difference in the **"quality" of APIs imported**
- Quality standards are very critical as they have a direct bearing on **the in-vivo performance** and **bio-availability of the product**
- CUP based comparability by the TPO also fails due to the following:
  - inability to establish '**uncontrolled nature**' of the transactions thrown up by the Customs databases
  - differences in **markets of import**
  - differing **economic characterization of the importer and seller**,
  - data obtained from customs not available on the public domain etc.

Any Questions?

Thank You!