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GLOBAL TRANSFER PRICING SERVICES

Issues Involving Comparability and Profit Based Methods in Transfer Pricing

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TAX

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Discussion Agenda

- **Background**
- **Transactional Profit Methods – Issues and Considerations**
- **Comparability - Issues and Considerations**
- **Lessons Learned**

Background

Background

Transfer Pricing Methods

- **OECD Guidelines[1] prescribe two types of transfer pricing methods**

Transaction Based Methods	Profit Based Methods
1. Comparable Uncontrolled Price ("CUP") 2. Resale Price Method ("RPM") 3. Cost Plus Method ("CPM")	4. Profit Split Method ("PSM") 5. Transactional Net Margin Method ("TNMM")

- **Profit based methods are most widely used**
  - US ninth Annual APA Report – Comparable Profits Method 63%, PSM 8%
  - Canada sixth annual APA Report – TNMM 40%, PSM 22%

- **OECD Committee on Fiscal Affairs issued draft notes on:**
  - Comparability issues while applying TP methods
  - Transactional Profits Methods

***1** - Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Co-operation and Development in 1995*

Background
Most Appropriate Method

- **Factors to consider when determining most appropriate method:**
  - Nature and class of international transaction
  - Class and functions performed by associated enterprises ("AEs")
  - Availability, coverage and reliability of data
  - Degree of comparability
  - Possible adjustments
  - Nature, extent and reliability of assumptions
- **TNMM used in majority of cases[1]**
- **Recent tribunal rulings examined issues related to comparability and most appropriate method.**

1 *– A CBDT official highlighted that an internal analysis of TP reports filed in Delhi office showed that assessees have used TNMM in more than 92 per cent of the cases – Source: Business Daily, New Delhi, October 18, 2008*

Transactional Profit Methods – Issues and Considerations

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Transactional Profit Methods
Characteristics

- **Indirect methods that use profitability to make inferences about pricing**
- **Wider acceptability, ease of implementation and more practical**
- **Product comparability requirement less stringent**

However,

- **TNMM is one-sided method**
- **Application break down when factors other than transfer prices have material impact on profits (Ex. start-up operations)**
  - **Example:** Revenue 100; Transfer Price per unit 2; Quantity 5; Other costs 82
  - Profits = 100 – (2 X 5) – 82 = 8
  - A 10% change in transfer price will have 1% change in net margin
  - A 10% change in other costs will have 8% change in net margin

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Transactional Profit Methods
OECD Draft Issue Notes

- No longer method of last resort
- Use of more than one TP method
- Robust functional analysis
- Transactions involving unique contribution
- Rigorous process for the application of TNMM
- Selection of appropriate PLI
- Determination of combined profit to be split
- Reliability of residual and contribution analysis
- Splitting of combined profit

Transactional Profit Methods

Practical Experience and Considerations

- **Robust functional analysis and documentation**
  - Key for successful defense
  - Emphasized by recent tribunal rulings
  - Should examine the functions, assets and risks of both parties to the transaction
  - Quantify and explain adjustments, if any made to increase the reliability of analysis (**Phillips Software Bangalore Tribunal ruling)**

- **Net margin analysis not appropriate where intercompany transactions only have a limited impact on profits**
  - Documentation should explain why transfer prices do not have a material impact on profits
  - Look for other methods ***or*** flip the tested party
  - Corroborate with alternate analysis

Transactional Profit Methods

Practical Experience and Considerations

- **Selection of Tested Party**
  - No discussion of tested party concept in Indian transfer pricing legislation
  - Recent Tribunal decision affirming necessity to select a tested party (**Delhi tribunal in the case of Development Consultants**)
  - Should be least complex party and should not own any intangibles
  - Challenges in cases where both parties have unique contributions
- **Views on OECD Draft Issue Notes**
  - Respect taxpayers evaluation and selection of method
  - Permit multi-year averaging
  - Standard procedures and guidance on profit split needed
  - Tax authorities should limit the information they request to make a reasonable assessment of taxpayer's transfer pricing

Transactional Profit Methods

Case Study – Start-up Considerations

- **Facts**
  - US Parent company with Indian subsidiary engaged in local distribution activities
  - Complete ramp-up for the Indian subsidiary expected to take 2 to 3 years
  - Indian subsidiary earned lower profits in the first year of its operations
- **Potential Issues**
  - TNMM analysis with India as the tested party may draw possible resistance from Indian tax authorities in accepting India standalone margin as arm’s length when Indian entity is earning low profits
- **Considerations**
  - Low profitability is because of reasons other than transfer pricing
  - Flip the tested party using Cost Plus Method instead of TNMM
  - Use gross profit analysis with RPM instead of TNMM
  - Make adjustments to account for start-up inefficiencies
  - Robust documentation

Comparability – Issues and Considerations

Background

Comparability Factors

Characteristics

Depends on type: tangible, intangible or service

Functional Analysis

Conduct is best evidence of risk bearing, should be consistent with control

Comparability Factors

Contractual terms

Where not written, deduce from conduct

Business Strategies

New product, market penetration. Plausible expectation of return

Economic Circumstances

Geography, size of market, date and time

Comparability Issues
OECD Draft Issue Notes

- Timing issues in comparability
- Internal comparables
- Sources of information and reliability
- Uncontrolled transactions
- Five comparability factors
- Selecting or rejecting external comparables
- Comparability adjustments
- Multiple-year data
- Aggregation of transactions
- Other issues (loss making comps, range)
- Documenting a search of comparables

Comparability Issues

Practical Experience and Considerations

- **Use of Contemporaneous Data**
  - Request for searches using non-contemporaneous data during recent TP audits
  - Decisions upheld require use of contemporaneous data (**Phillips Software ruling**)

- **Internal comparables**
  - Internal comparables considered better than external
  - Identification and suitable adjustments for FAR differences

Example: Sale to related party – 950 units; Sale to unrelated party – 50 units

- May not be appropriate to compare prices or profitability of two segments when significant volume differences exist
- If possible (and if necessary), make suitable adjustments for volume and other relevant factors

Comparability Issues

Practical Experience and Considerations

- **Use of Secret Comparables**
  - Fairness and transparency of secret comparables
  - Information asymmetry between taxpayers and tax administrations
  - KPMG member firms' view: Disallow tax authorities use of secret comparables

- **Use of Controlled Transactions**
  - OECD Guidelines - controlled transactions may provide indications on an industry sector's behavior and trends
  - Taxpayers profits / prices outside the norms of its competitors does not mean that the controlled transactions are not at arm's length
  - Recent rulings restricts use of comparables with related party transactions (**Phillips Software ruling and Sony India Limited ruling**)
  - Possible alternatives: use of consolidated data ***or*** broadening of search process

Comparability Issues
Practical Experience and Considerations

- **Comparability Adjustments**
  - No common platform of principle and concepts for comparability adjustments
  - Recent tribunal rulings affirms the acceptability of reasonable adjustments:
    - **Phillips Software** : Working Capital and Risk Adjustment
    - **Sony India (P) Limited** : Adjustment on account of risk profile (20 percent)
    - **Development Consultants** : Working capital and marketing adjustments
    - **Egain Communications** : Adjustment on account of accounting policy differences
- **Loss making comparable companies**
  - KPMG member firms' view: companies can often lose money at arm's length
- **Use of Multiple Year Data**
- **Comparable companies with extreme profitability**
- **Issues related to captives**

Lessons Learned

- Robust functions, assets and risks analyses
- Robust selection process for the application of the TNMM
- Upfront comparability adjustments
- Careful and robust documentation to support low profits or losses
- Careful evaluation of most appropriate method

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