Method of Computation
Transactional Net Margin Method

Rakesh Alshi | 14 February 2015
Contents

• Arm’s Length Price
• Transfer Pricing Methods
• Transactional Net Margin Method (‘TNMM’)
  ‒ Meaning of TNMM
  ‒ Strengths and Weaknesses
  ‒ Steps involved in application of TNMM
  ‒ Case Studies on application of TNMM
  ‒ Experiences and Judicial Rulings in India
• Base Erosion and Profit Shifting (‘BEPS’)

Legal Provisions

Chapter X – Special provisions relating to avoidance of tax

Computation of arm’s length price.

Section 92.
Computation of income from international transaction having regard to arm’s length price.
(1) “Any income arising from an international transaction shall be computed having regard to the arm’s length price”

Section 92C.
(1) The arm’s length price in relation to an international transaction \[^{86}\] [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\[^{88}\], 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.
Arm’s Length Price

Definition

- Price applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions

Set out Various Methods for “Arm’s Length Price”

Section 92C of Indian Income-tax Act, 1961

Rule 10B of Indian Income-tax Rules, 1962

* The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations also set out various methods for establishing the arm’s length price

- If more than one comparable price is obtained using above methods, then the arm’s length price would be ‘Arithmetic Mean’ of comparable prices
Selection of TP methods
Transfer Pricing Methods Overview

Methods

Traditional Transaction Methods
- Comparable Uncontrolled Price (CUP)
- Resale price method (RPM)
- Cost Plus

Transactional Profit Methods
- Profit Split
- Transactional Net Margin Method (TNMM)

Other Method*

*The CBDT vide Notification No. 18/2012 has prescribed the application of the sixth method named as “Other Method” for computation of arm’s length price. (Rule 10AB of the Income-tax Rules, 1962)
Introduction to TNMM
TNMM

Introduction

Mechanism to apply TNMM -- Rule 10B(1)(e) of the Income Tax Rules, 1962 as under:

“(i) the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm’s length price in relation to the international transaction.”
TNMM
Meaning

• Examines the net profit margin relative to an appropriate base that a taxpayer realizes from a controlled transaction
  – Costs
  – Sales
  – Assets
  – Other relevant base
• Most frequently used method
  – In India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method / cost plus method / resale price method
• Level of Comparability
  – Broad level of product comparability
  – High level of functional comparability

Usually regarded as an indirect and one-sided method, but is most widely used
TNMM
Strengths & Weaknesses

**Strengths:**

- Applicable for any type of transaction
- Supplements analysis under other methods
- Net margins are more tolerant to some functional differences
- Shortcomings of Gross Margin analysis
  - Classification of expenses in the gross margin frequently makes it difficult to evaluate the comparability of gross margins
  - Use of net margins may avoid the problem
- Practical solution to otherwise insoluble transfer pricing problems
TNMM

Strengths & Weaknesses

**Weakness:**

- Net margin of a tax payer
  - can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect on price or gross margins. (e.g. age of plant & equipment, self financing vs. borrowing, degree of business experience, management efficiency)

- Impact due to other factors
  - Application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits

Potential inaccuracies to some extent can be mitigated by application of arm’s length range concept
TNMM
Steps involved in application

Grouping of transaction
• Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction

Selection of tested party
• Least complex entity – Indian entity vs foreign entity
• Availability of appropriate data
• Does not own valuable intangibles that contribute to the generation of profits

Benchmarking exercise
• Search on databases
  • Local databases i.e. Prowess and Capitaline
  • Foreign databases i.e. AMADEUS (PAN European), Compustat (North American), etc.
• Similar industry classification
• Appropriate quantitative filters
  • such as Manufacturing sales >75% ; R&D exp >5% ; Advertisement exp >5%.; RPT = 0
• Review financial and textual information available
### TNMM

Steps involved in application

**Profit Level Indicators (‘PLI’):**

<table>
<thead>
<tr>
<th>PLI</th>
<th>Formula</th>
<th>Typically used for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Total Costs</td>
<td>Operating profit / Total Costs</td>
<td>Contract Manufacturer / Toll Manufacturer / Service Provider</td>
</tr>
<tr>
<td>Return on Sales</td>
<td>Operating Profit / Sales</td>
<td>Manufacturer / Distributor</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>Operating Profit / Operating assets</td>
<td>Manufacturer / Asset Intensive business</td>
</tr>
<tr>
<td>Return on Capital Employed</td>
<td>Operating Profit / Capital Employed</td>
<td>Financial Transactions</td>
</tr>
<tr>
<td>Return on Value Added Expenses</td>
<td>Operating Profit / Value Added Expenses</td>
<td>Agents</td>
</tr>
</tbody>
</table>
Steps involved in application

**Adjustments**
- Exclude non-operating income and expenses
- Working Capital Adjustment – Inventory, Receivables and Payables
- Risk adjustment, capacity utilization adjustment, etc.
- Accounting adjustment
- e.g. depreciation adjustment, adjustment for customs duty
- Start-up costs / termination costs

**Computation of ALP**
- Usage of single year data / multiple year data
- Computation of arithmetic mean
- Use of +/- range
  - 1% in case of wholesale traders and 3% in case of others as notified by Central Government in April, 2013
- Arm’s length range – Rules to be notified

**Comparability**
- Product comparability vs functional comparability
Arm’s Length Price
What has changed?

- Business Purpose Test
- Real Income Principle
- Burden of Proof
Practical Case Studies on TNMM
Case Studies
Case 1

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase from I Co. A</td>
<td>800</td>
</tr>
<tr>
<td>Sales to 3rd party</td>
<td>1000</td>
</tr>
<tr>
<td>Profit</td>
<td>200</td>
</tr>
<tr>
<td>OP / Sales</td>
<td>20%</td>
</tr>
</tbody>
</table>

PLI of OP / Sales
Case Studies

Case 2

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Services provided to I Co. A (A)</td>
<td>1100</td>
</tr>
<tr>
<td>Operating Exps. (B)</td>
<td>1000</td>
</tr>
<tr>
<td>Profit (C = B – A)</td>
<td>100</td>
</tr>
<tr>
<td>OP / TC</td>
<td>10%</td>
</tr>
</tbody>
</table>
Case Studies
Case 3

Segmental – AE and Non AE business

<table>
<thead>
<tr>
<th>Particulars</th>
<th>AE</th>
<th>Non – AE</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>110</td>
<td>100</td>
<td>210</td>
</tr>
<tr>
<td>Purchases</td>
<td>85</td>
<td>80</td>
<td>165</td>
</tr>
<tr>
<td>Other Administrative Expenses</td>
<td>12</td>
<td>10</td>
<td>22</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>13</td>
<td>10</td>
<td>23</td>
</tr>
<tr>
<td>OP/Sales</td>
<td>11.81%</td>
<td>10%</td>
<td>10.95%</td>
</tr>
</tbody>
</table>

Comparability when:

- Internal comparability exists - Internal TNMM
- No internal comparability exists - External TNMM
Case Studies

Case 4

Computation of Arm’s Length Price:

- **Independent Enterprise Transaction** = 15/150 = 10%
- **Arm’s Length Operating Margin** = 120 * 10% = 12
- **Arm’s Length Price** = 120 - 12 = 108
Case Studies
Case 5

Facts

- Indian Auto Manufacturer
  - Full fledged manufacturer
  - R&D and IP with overseas parent
- Limited international transaction - Import of clutch assembly
- Financial Data of Indian entity:

<table>
<thead>
<tr>
<th>Particular</th>
<th>Amount in INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues from end customers</td>
<td>100</td>
</tr>
<tr>
<td>Other operating costs</td>
<td>13</td>
</tr>
</tbody>
</table>
Case Studies
Case 5

Analysis

- Most Appropriate Method: given the availability of required data, the TNMM is the best method
- While applying the TNMM method, due consideration must be given to the following
  - Industry characteristics
  - FAR analysis
  - Differences if any for which adjustments need to be made

Industry Characteristics

- Overcapacity
- Capital Intensive - Plant & Machinery, R&D, etc.
- Pressure on Innovation / Product Launches
- Global scale v/s local requirements
- Extreme Volume and Price risks
- Complex supply chains
Case Studies
Case 5

Industry Analysis

Growth in sales

Auto Sales growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY09</td>
<td>4%</td>
</tr>
<tr>
<td>FY10</td>
<td>27%</td>
</tr>
<tr>
<td>FY11</td>
<td>28%</td>
</tr>
<tr>
<td>FY12</td>
<td>12%</td>
</tr>
<tr>
<td>FY13</td>
<td>3%</td>
</tr>
<tr>
<td>FY14</td>
<td>4%</td>
</tr>
</tbody>
</table>
Case Studies
Case 5

**Conclusion**

- Indian entity being the simpler entity is the tested party
- Profit level indicator
  - Cost based PLI can’t be used as the cost is affected by transfer prices
  - Asset based PLI can’t be used as sufficient information of comparable companies’ asset base is not available
  - Net Profit Margin (Net operating profits/sales) seems to be the most appropriate
- Internal TNMM not possible because of given facts and circumstances
- External benchmarking suggest that the Indian entity should earn *net profit margin of 5 percent*

```
Transfer Pricing = Final sales price – Arm’s length net profit margin – Operating expenses of tested party
```

- Therefore, transfer price = INR 100 – INR 5 - INR13 = INR 82
Case Studies
Case 6

Facts

• A Ltd., an Indian Company manufactures pens for its three foreign subsidiaries of its Swiss parent company

• Swiss Parent owns the right to the product formulae of the pens

• A Ltd. does not have any internal comparable transactions

• The international transaction is sale of manufactured pens by A Ltd. to its foreign subsidiaries
Case Studies

Case 6

**Choice of Methods**

- Due to absence of internal and external CUPs, CUP method is rejected
- Since A Ltd. is not a distributor of pens to third parties, RPM is rejected
- Due to unavailability of gross margins information pertaining to uncontrolled transaction, CPM method also cannot be applied
- Data from external database can be obtained based on appropriate functional analysis
- Since, A Ltd. performs least complex functions and also does not possess valuable intangibles, it is treated as a tested party
- Net cost plus is applied as an appropriate PLI for comparability
## Case Studies

### Case 6

#### Comparability Analysis

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount in INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Ltd’s. cost of goods sold</td>
<td>1000</td>
</tr>
<tr>
<td>A Ltd’s operating expenses</td>
<td>500</td>
</tr>
<tr>
<td>Total Cost</td>
<td>1500</td>
</tr>
<tr>
<td>Sale Price earned by A Ltd.</td>
<td>1650</td>
</tr>
<tr>
<td><strong>Mark up earned</strong></td>
<td><strong>150</strong></td>
</tr>
<tr>
<td>Net cost plus earned by A Ltd.</td>
<td>10%</td>
</tr>
<tr>
<td>Net cost plus earned by independent manufactures arrived by search process using database</td>
<td>8% (say)</td>
</tr>
</tbody>
</table>

Since net cost plus earned by A Ltd. is higher than that of net cost plus earned by independent entities, transactions of A Ltd. with its AEs are at arm’s length.
Experiences and Judicial Rulings in India
### Judicial Rulings

#### Issues
- TNMM is the most common method followed – basically mixture of TNMM and Cost Plus Method
- Aggregation approach followed
- For trading company – RPM vs. TNMM

<table>
<thead>
<tr>
<th>Ruling</th>
<th>Observations/ Conclusions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Philips Software (Bangalore SB)</td>
<td>Where no infirmity exists in the TP study conducted by the taxpayer, the TPO cannot disregard the same.</td>
</tr>
</tbody>
</table>
| MSS India (Pune Tribunal)     | • **Revenue cannot arbitrarily reject the method** adopted by the taxpayer without providing detailed reasons for such rejection,  
                                • **Factors laid down in the Rule 10C to be followed** for selection of the most appropriate method. |
| UCB Ruling (Mumbai Tribunal)  | **CUP method requires a high degree of comparability** with regard to quality, contractual terms, level of market, geography involved, date of transaction, intangible property, foreign currency and alternatives available with buyer and seller. |
| Kodak Polychrome Graphics (Mumbai Tribunal) | The basic tenet of the TP mechanism is to determine the most appropriate method for determination of ALP. Assessee has the **initial burden of demonstrating** as to which method is most appropriate for benchmarking of its transactions and of justifying that it is at ALP. |
## Judicial Rulings

<table>
<thead>
<tr>
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<th>Observations/ Conclusions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Genisys Integrating System (Bangalore Tribunal)</td>
<td>Internal TNMM preferred over external TNMM where similar services provided to AE and non-AE and reliable internal data available.</td>
</tr>
<tr>
<td>L’Oreal India (Mumbai Tribunal)</td>
<td>• Use of Resale Price Method upheld over TNMM where assessee bought products from AE and resold them without further processing, • There is no order of priority of methods to determine ALP.</td>
</tr>
<tr>
<td>Arvind Mills Ltd. (Ahmedabad Tribunal)</td>
<td>While applying CUP the comparability between controlled and uncontrolled transactions should not be only judged from the point of product comparability, but should also take into consideration the effect on price of other broader business functions. <strong>Comparability under this method depends on close similarities with respect to various factors.</strong> (eg. differences in contractual terms or economic conditions, geographical areas, risks assumed, functions assumed, etc.).</td>
</tr>
<tr>
<td>CISCO Systems (Bangalore Tribunal)</td>
<td>When the assessee cannot be held to be a trader or distributor of the spare parts, it is clear that the resale price method is not applicable for arriving at the ALP of the international transactions. TNMM applicable where no other method applicable.</td>
</tr>
<tr>
<td>J.P.Morgan India (Mumbai Tribunal)</td>
<td>If comparable price data is available and differences in FAR profile of taxpayer’s transactions with AEs versus its transactions with third parties can be quantified, the <strong>CUP method should be preferred over the TNMM.</strong></td>
</tr>
</tbody>
</table>
### Judicial Rulings

<table>
<thead>
<tr>
<th>Issue</th>
<th>Ruling</th>
<th>Observations / Conclusions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital adjustment</td>
<td>Avineon India P. Ltd.</td>
<td>ITAT held that working capital adjustment necessary for adequate comparability</td>
</tr>
<tr>
<td></td>
<td>Ariston Thermo India Limited</td>
<td>ITAT allowed capacity adjustment while working out tested party margin</td>
</tr>
<tr>
<td>Risk Adjustment</td>
<td>D.E. Shaw India Software (P) Ltd.</td>
<td>ITAT relied on assessee’s own case for AY 2007-08 and observed that CIT(A) had analysed the issue in detail and ITAT confirmed CIT(A) order granting risk adjustment at 1%. Thus, the ITAT in the current year, upheld the risk adjustment.</td>
</tr>
<tr>
<td>Aggregation of transactions</td>
<td>Essar Steel Ltd.</td>
<td>ITAT upheld aggregation of sales transactions to AE, deletes TP addition</td>
</tr>
<tr>
<td></td>
<td>Star India P. Ltd</td>
<td>ITAT held that ALP not to be determined by clubbing different international transactions</td>
</tr>
</tbody>
</table>
Some experiences involving application of TNMM

- Business strategies require strong documentation
  - Entrepreneurial risk, start up phase, market penetration, excess capacity, etc.
- Business reasons for losses not easily accepted
- Use of foreign tested party – a debatable issue
- Regulations do not prohibit foreign comparables
  - however local comparables are preferred
- Multiple year data vs. tax year data
  - Regulations permit 2 additional years, provided they have influence on determination of transfer prices
Some experiences involving application of TNMM

• Lesser emphasis on economic factors/business strategies
  – start up phase, market penetration, excess capacity, etc.
• High mark-ups for captive service providers (ITES/BPO industry)
• Use of secret comparables
• Transfer Pricing adjustment on whole entity including to unrelated portion
• Mark-up on pass through costs
Base Erosion and Profit Shifting (‘BEPS’)
Arm’s length principle vs. formulary apportionment

**Action Plan:**

- “Alternative income allocation systems [i.e. alternative to the arm’s length principle], including formula based systems, are sometime suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation. Nevertheless, special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws.” [Underlining added]
## BEPS action plan: overview

<table>
<thead>
<tr>
<th>Action 1: Address the tax challenges of the digital economy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>“Gaps”</strong></td>
</tr>
<tr>
<td>i. Establishing international coherence of corporate income taxation</td>
</tr>
<tr>
<td>Action 2: Neutralize the effects of hybrid mismatch arrangements</td>
</tr>
<tr>
<td>Action 3: Strengthen controlled foreign company (CFC) rules</td>
</tr>
<tr>
<td>Action 4: Limit base erosion via interest deductions and other financial payments</td>
</tr>
<tr>
<td>Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Action 15: Develop a multilateral instrument</td>
</tr>
</tbody>
</table>
Proposed Compliance Documentation

- New guidelines adopt 3-tiered approach

Country-by-Country Template

- Key financial information on all group members on an aggregate country basis with an activity code for each member

Master File

- Key information about the group's global operations including a high-level overview of a company's business operations along with important information on a company's global TP policies with respect to intangibles and financing

Local File

- Information and support of the intercompany transactions that the local company engages in with related parties

Local law will determine the language in which the documentation must be submitted. Countries are encouraged to permit filing in commonly used languages and request translation after submission.
Appendix
Introduction of Range Concept

- Arithmetic mean leads to distorted results due to extreme values (outliers); Inter-quartile range would automatically eliminate outliers
  - Extreme results indicate abnormal business conditions; these are generally excluded from arm’s length range

- The Finance Minister in the budget speech has proposed the introduction of range concept for determination of arm’s length price
  - Arithmetic mean concept to continue where number of comparables is inadequate
  - Relevant data is under analysis and appropriate rules will be prescribed

- Statistical tools like inter-quartile range enhance reliability of comparability analysis

- Range concept is internationally accepted and in existence in countries like the USA, UK, Australia, Singapore, etc.
Use of Multiple year Data for Comparability Analysis

- Rule 10B(4) provides for benchmarking based on relevant single year data; prior year data up to two years data may be used if it has an influence on determination of transfer price
  - Insufficiency of current year data as on return filing date - impossibility of performance
  - TPOs use current year data available at time of TP assessments (generally 3 years after closure of financial year)
- The Finance Minister in the budget speech proposed to amend the regulations to use multiple year data
- Detailed rules to be prescribed
- Use of multiple year internationally accepted and in existence in countries like the USA, Australia, China, UK, South Africa, Germany, etc.
References and Contact details

Reference materials

• Income Tax Act, 1961
  http://law.incometaxindia.gov.in/DIT/In
come-tax-acts.aspx

• Income Tax Rules, 1962
  http://law.incometaxindia.gov.in/DIT/in
come-tax-rules.aspx

• ICAI Guidance notes
  http://www.icai.org/new_post.html?pos
t_id=501&c_id=222

• OECD Guidelines

• Transfer Pricing Law and Practice
  in India – By Deloitte and CCH

• Judicial Rulings
Questions

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Thank you!