

# FAR Analysis, Selection of Most Appropriate Method, Application of Methods (CUP & RPM) and Case Studies with reference to Specified Domestic Transactions



## Bombay Chartered Accountants' Society

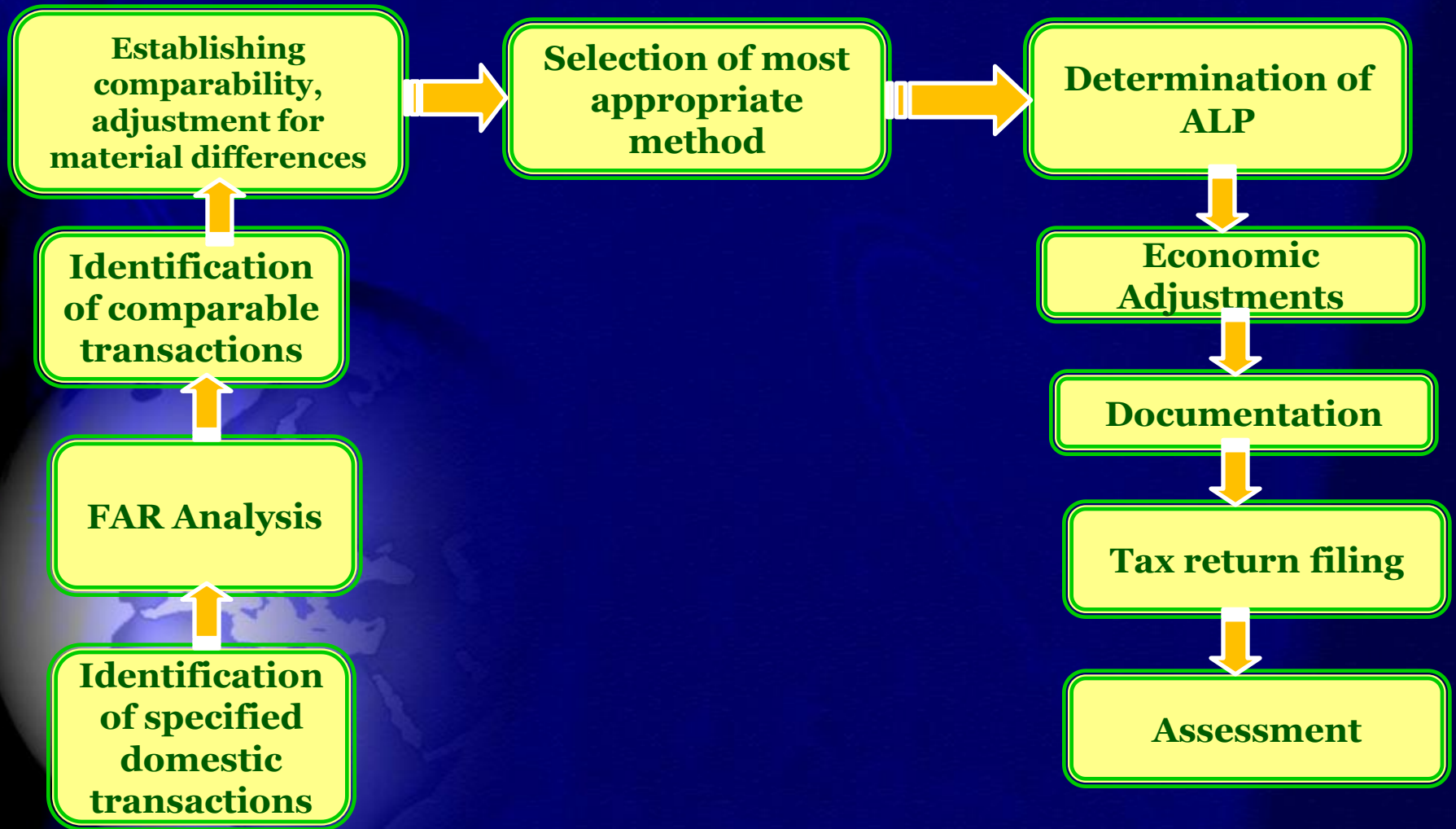
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# AGENDA

- ∞ Arm's Length Price
- ∞ Functional, Asset and Risk Analysis (FAR)
- ∞ Comparability Analysis
- ∞ Selection of Most Appropriate Method
- ∞ Application of Methods
  - CUP
  - RPM
- ∞ Practical Issues and Case Study

# Transfer Pricing Process



# Arm's Length Price

- ❧ Section 92F(ii) of the Indian Transfer Pricing regulation (TPR)
- ❧ “Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associate enterprises, in uncontrolled conditions”
- ❧ Under Rules 10B to 10E of Income Tax Rules, 1962 (Rules)
- ❧ “Uncontrolled transaction” – transaction between enterprises other than associated enterprises, whether resident or non-resident

# Specified Domestic Transaction

∞ Amendment to the existing domestic law,

As per Section 40A(2)

Computation of any expenditure being excessive or unreasonable being a specified domestic transaction, the computation of **fair market value** of such expenditure, will be at **arm's length price**

The concept of ALP is more scientific than the concept of FMV

As per the explanation to section 80-IA newly inserted, the term “*market value*” shall mean:

- i. The price that such goods or services would ordinarily fetch in the open market; or
- ii. The arm’s length price as defined in clause (ii) of section 92F



# Associated Enterprise (as per Rules)

- ∞ Enterprise covered by international transaction
- ∞ Persons referred to under Sec. 40A(2)(b)
- ∞ Units or undertakings or business covered under Sec. 80-IA(8); or persons referred under Sec. 80-IA(10)



# Functional Analysis - Approach

- ☞ Understanding the business model of the taxpayer
  - ☞ Functions performed by the company
  - ☞ Assets utilised by the company
  - ☞ Risks assumed by the company



- ☞ Study the characteristics of the transactions
  - ☞ Assists in determining the contribution of the taxpayer vis-a-vis the AEs in the SDT
  - ☞ Identify suitable comparables
- ☞ Benchmarking with uncontrolled comparables
  - ☞ Economic adjustments for functional differences based on FAR analysis
- ☞ Determination of arm's length price



# Comparability Analysis

- ∞ Arm's length principle is generally based on comparison of the conditions in controlled transaction with the conditions in transaction between independent enterprises
- ∞ For Comparison, *economically relevant characteristics of the situations being compared must be sufficiently comparable*
- ∞ In case of material differences, appropriate adjustments to be made to establish arm's length conditions.
- ∞ For making adjustments, it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings

**Comparability Analysis is the heart of transfer pricing analysis**

# Factors Determining Comparability

Rule 10B(2) of Rules & OECD TP  
Guidelines –

FIVE KEY FACTORS –




- ∞ Characteristics Of Property or services
- ∞ Functional Analysis
- ∞ Contractual Terms
- ∞ Economic Circumstances
- ∞ Business Strategies

# Characteristics Of Property or services

- ∞ Differences in specific characteristics of property or services often account at least in part, for differences in value in open market
- ∞ Important characteristics to be taken into account
  - ∞ Physical features of property
  - ∞ Its Quality & Reliability
  - ∞ Availability
  - ∞ Volume of supply
  - ∞ Nature and extent of services rendered





∞ For Intangible Property ,  
factors to be considered to  
establish comparability...

- Form of transaction i.e. licensing or sale
- Type of Property (patent, trademark, or knowhow)
- Duration & Degree of protection
- Anticipated Benefits from use of intangible property

# Contractual Terms

- ∞ Contractual terms of transaction define explicitly or implicitly how responsibilities, risks and benefits are to be divided between parties
- ∞ Thus analysis of contractual terms is not only important for comparability analysis but also for FAR analysis
- ∞ Economic circumstances are relevant to determine market comparability

# Economic Circumstances

∞ To establish market comparability, factors like

- geographic location
- size of market
- extent of competition
- relative competitive positions of buyers and sellers
- availability of substitute goods and services
- level of demand and supply
- consumer purchasing power, government regulations



# Business Strategies

∞ Business strategies to be examined in determining comparability for TP purposes

∞ Business strategies would take into account

∞ Innovation, New product development

∞ Risk Aversion & Diversification

∞ Market Penetration schemes

# Factors.....

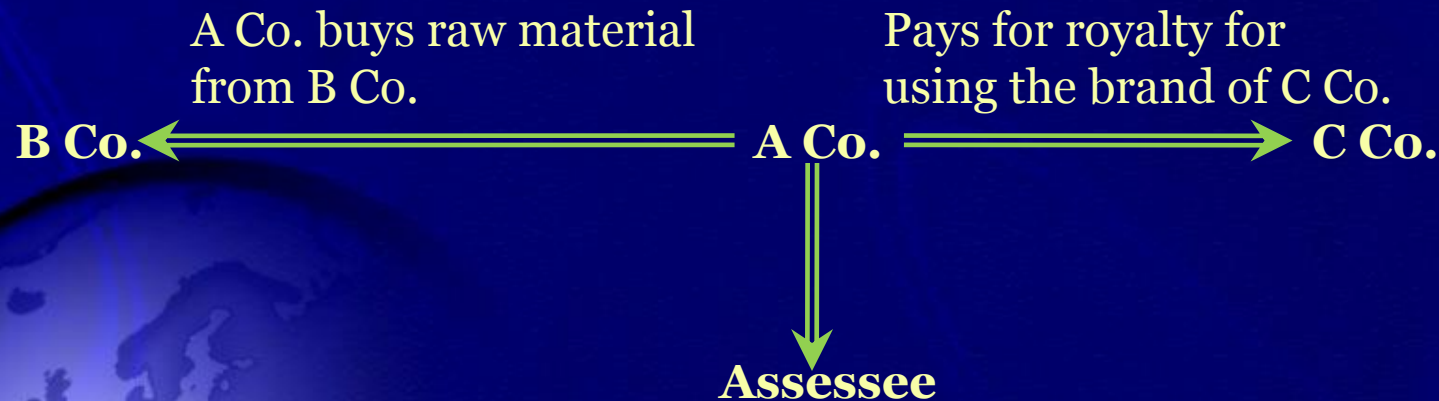
## Some Key Issues –

- What if a particular strategy leads to reduction of current profits in anticipation of future profits?
- Taxpayer's strategy vis-à-vis strategy followed by comparables?
- What if business strategies fail and future projected benefits don't realize?
- Hence it is important for taxpayer , not only to demonstrate before Revenue Authorities, the projected benefits arising out of particular business strategy but also establish viability of such strategy from an uncontrolled perspective



# Case study 1

## To understand FAR analysis and comparability analysis



☞ B Co. and C Co. are both related parties as recognized under section 40A(2)(b)

☞ A Co. manufactures bottles with the raw materials provided to it by B Co. and uses the brand name of C Co. and prints them on the bottles and sells it in the market

# FAR Analysis for the given company

## ∞ Functions Performed

- ∞ Processing to manufacture the bottles
- ∞ Use of brand of C Co.
- ∞ Performs marketing, distribution and logistics functions

## ∞ Assets utilised

- ∞ Machinery to manufacture the bottles
- ∞ Infrastructure
- ∞ Human resources

## ∞ Risks assumed

- ∞ Inventory Risk
- ∞ Stock Obsolete risk
- ∞ Regulations risk
- ∞ Human resource turnover risk
- ∞ Business risk

## ∞ Contractual terms

- ∞ Credit period
- ∞ No. of days delivery
- ∞ Quantity
- ∞ Quality assurance/Inspection

# Most Appropriate Method (MAM)

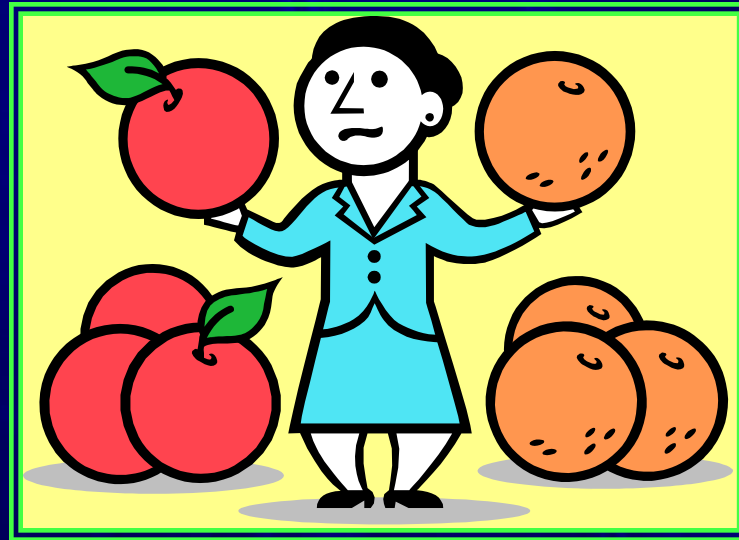
∞ The Act prescribes selection of the MAM from the six specified methods; having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe

∞ The six methods:

- a) Comparable Uncontrolled Price Method (CUP)
- b) Resale Price Method (RPM)
- c) Cost Plus Method (CPM)
- d) Profit Split Method (PSM)
- e) Transaction Net Margin Method (TNNM)
- f) Other method prescribed by CBDT (prescribed by Rule 10AB)

<b>Method</b>	<b>PLI</b>	<b>Degree of comparability required is</b>	<b>With respect to</b>
CUP	Price	Very High	Similar products & surrounding conditions
RPM	GP/Sales	High	Distribution of products
CPM	GP/Direct and Indirect Cost of Production	High	Manufacture, assembling or production of tangible products or provision of services
PSM	OP/Assets or Capital Employed or Cost	Moderate	Transfer of unique intangible or multiple inter related international transactions
TNMM	OP/OC or OI or operating assets or capital employed	Moderate	Applied when other methods fail
Any other Method	Price	Very High	Considers price charged/paid or would have been charged/paid (quotation)

# Comparable Uncontrolled Price (CUP) Method





The CUP method compares:

- ∞ the **price charged** for property or services transferred
- ∞ in a controlled transaction with that in a **comparable uncontrolled transaction**
- ∞ in comparable circumstances.

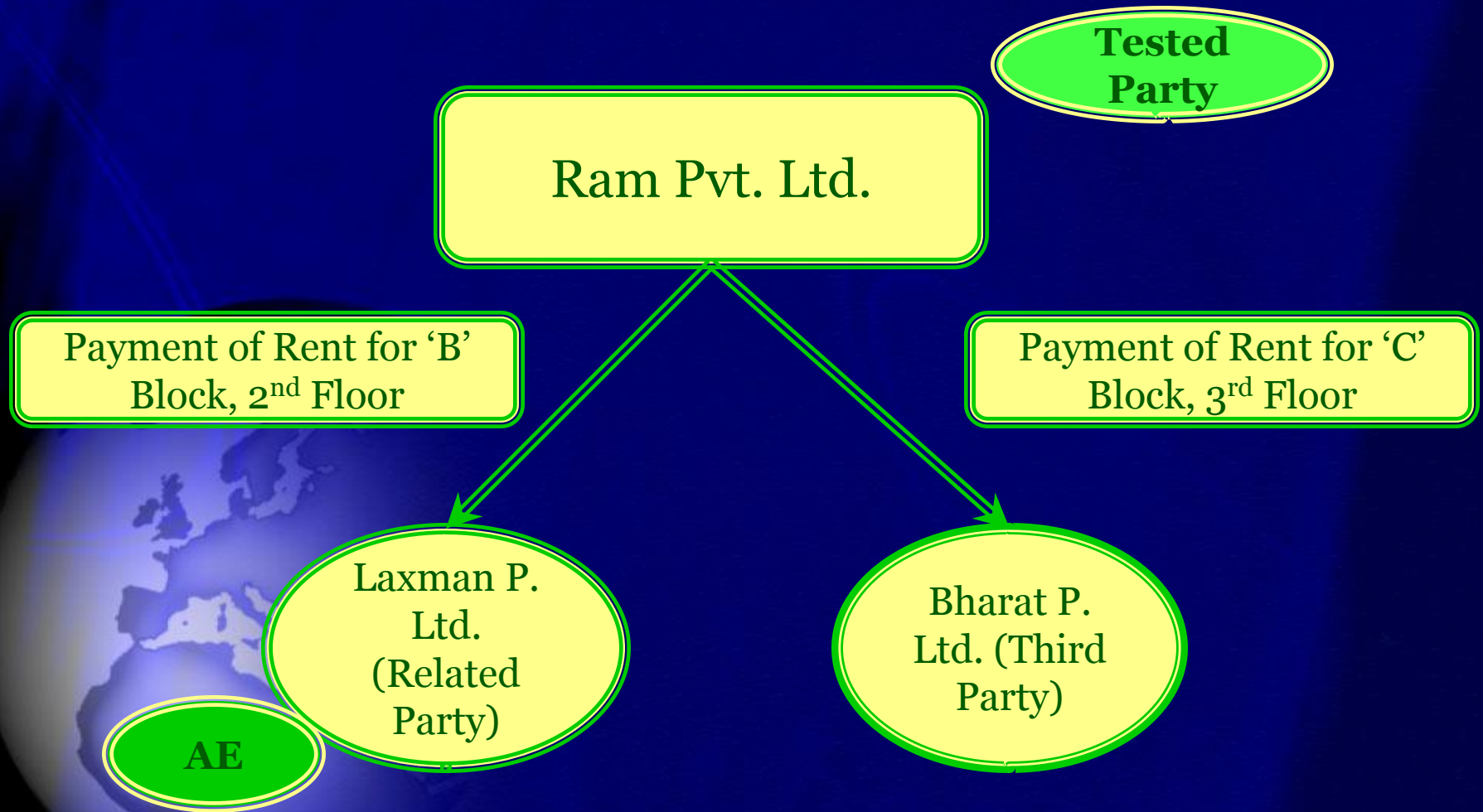
- ∞ An ‘uncontrolled transaction’ is comparable to a controlled transaction if
- ∞ **reasonably accurate adjustments** can be made to eliminate the effect of the differences

# Application of CUP

Illustrations –

- ❧ In case of transfer of homogeneous items, such as traded commodities.
- ❧ Interest rates charged on loans between related parties which are dependent upon market quoted rates, etc.
- ❧ In case of transactions which are dependent on publicly available market quotations.
- ❧ Similar transactions between AEs and between AE and third party

# Case Study 2





# Why CUP?

- ∞ The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identifiable (Rule 10B(1)(a))
- ∞ In the case the uncontrolled transaction will be the one with Ram Pvt. Ltd. and Bharat Pvt. Ltd., since there is a direct comparable available CUP method is used to benchmark the transaction

# Case Study (Contd.)

Particulars	'B' Block	'C' Block
Security Deposit	1,00,00,00,000	20,00,00,000
Actual Rent (p.a.)	50,00,00,000	25,00,00,000
Carpet Area (sq. ft.)	90,000	40,000
Rate per sq. ft. (p.m.)	463	521

❧ Whether the above transaction of payment of rent is at arm's length ?

# Case Study (Contd.)

Particulars	'B' Block	'C' Block
Security Deposit	1,00,00,00,000	20,00,00,000
Imputed Interest* @10%	10,00,00,000	2,00,00,000
Interest p.m. Per sq. ft. (A)	93	42
Rate per sq. ft. (p.m.) (B)	463	521
A+B	556	563

\*SBI Prime Lending Rate @ 10%

# Resale Price Method (RPM)



# Applicable when?

- ∞ RPM is suitable when the entity performs basic sales, marketing and distribution functions and there is little or no value addition by the reseller prior to resale of goods
- ∞ It is less useful when goods are further processed or incorporated into other products and where intangibles are used

# Use of RPM

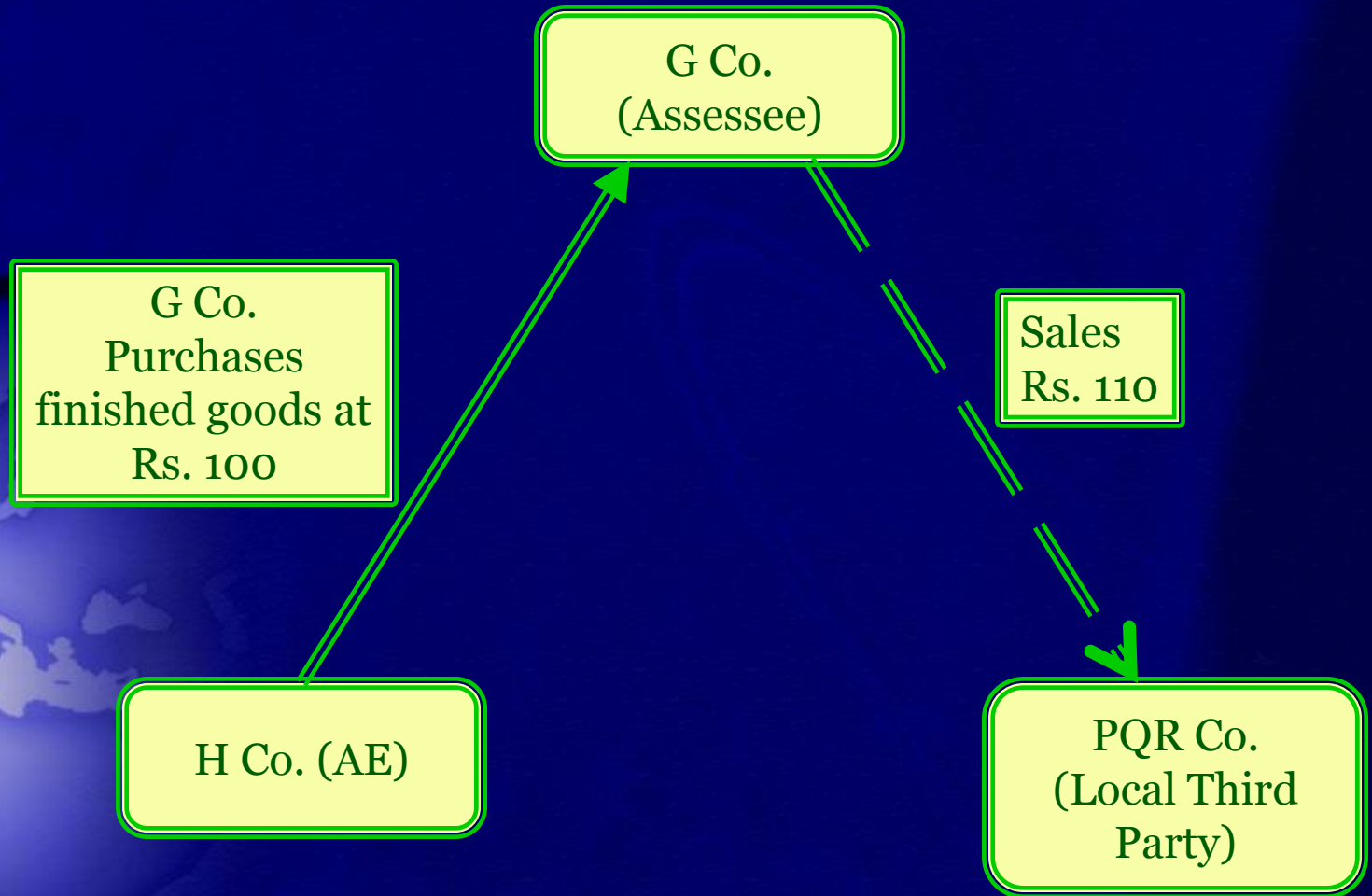
- ∞ In RPM a comparison is made between the gross margins earned by an enterprise in a controlled transaction vis-à-vis an uncontrolled transaction
- ∞ RPM, requires high degree of functional comparability between controlled and uncontrolled transactions
- ∞ Similar to CUP, RPM can be applied by way of internal RPM and external RPM

# Difficulties in applying RPM

∞ Indian Generally Accepted Accounting Principles (GAAP) does not mandate the companies to disclose the gross margins separately

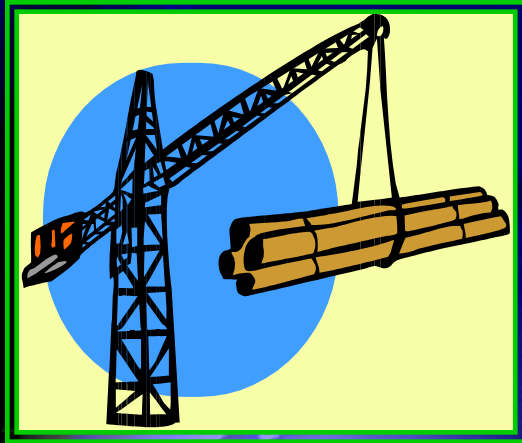
∞ Thus, due to lack of financial data of comparable companies at gross level, it may not be possible to apply RPM using external databases

# Case Study 3





# Facts



∞ G Co. purchases finished goods ('pipes') from H Co. (G Co's Associated Enterprise) at Rs. 100 and sells it to PQR Co.- an Indian company at Rs. 110

∞ G Co. also buys finished goods ('pipes') from third party at 200 and sells the same to the third party at 222

# Why RPM should be selected?

∞ The price at which property purchased or services obtained by the enterprise from an AE is resold or are provided to unrelated enterprise, is identifiable; (Rule 10B(1)(b))

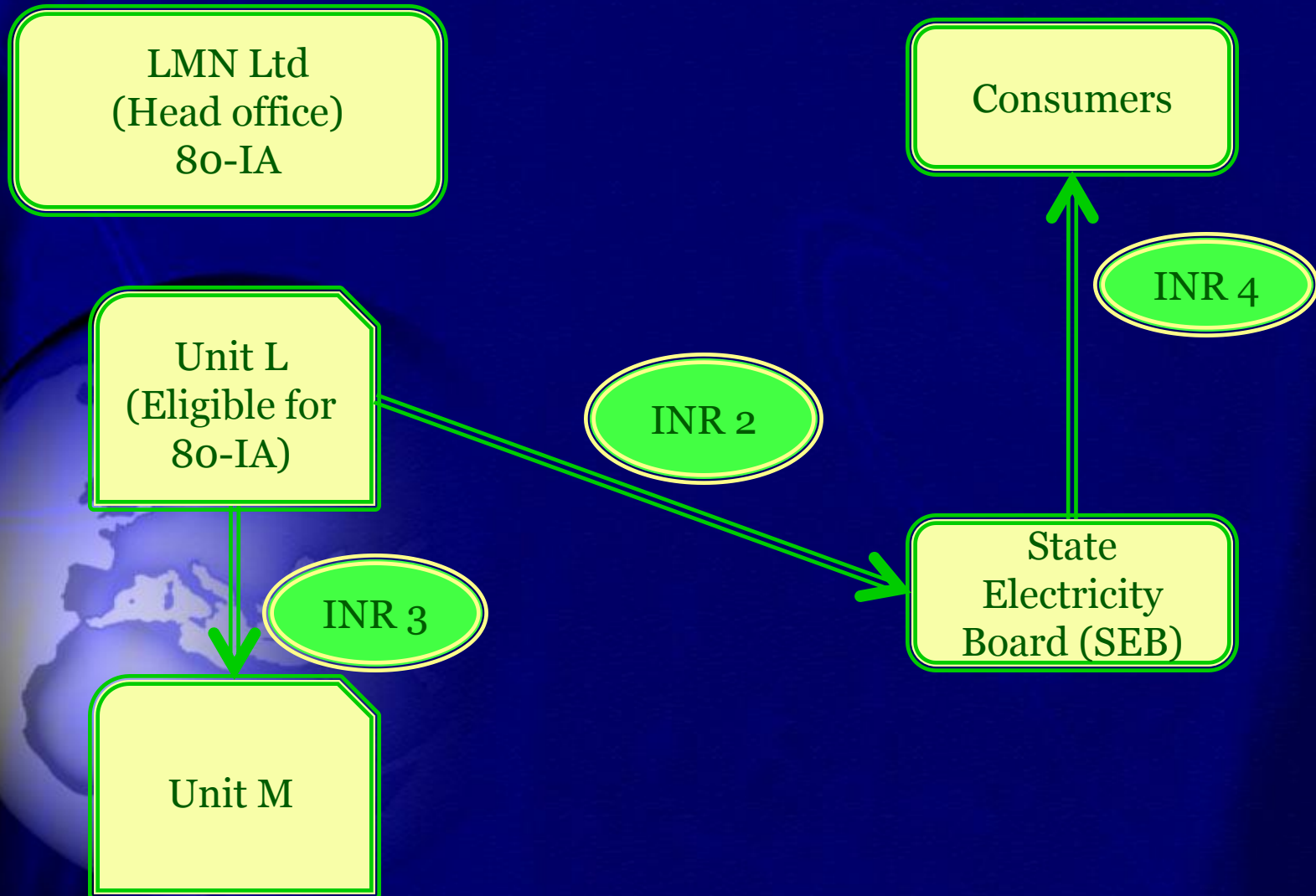
∞ In the case, the gross margins at which the transaction is made with the AE and the third party are available, hence RPM is selected



Particulars		Transaction with AE	Transaction with third party
Cost of purchase	A	100	200
Selling price	B	110	222
Gross Profit	$B - A = C$	10	22
Gross profit as a percentage to Selling price	$C / B = D$	9.09%	9.91%
Arm's length Gross profit using the gross margin of the third party	$9.91\% * B = E$	10.90	-
Reducing the arm's length gross profit from the sales transaction	$B - E$	99.10	-
Benefit of +/- 1%	$A * (100 - 1)\%$	99.00	
	$A * (100 + 1)\%$	101.00	

Thus, the arm's length price fits between the range of 99-101 and hence, the international transaction is at **arm's length**

# Case Study 4



# Case Study (Contd.)

## ∞ Facts

∞ Unit L provides power supply to Unit M and SEB.

∞ SEB supplies power to customers @ Rs. 4 per unit

∞ Rate charged to Unit M - Rs. 3 per unit

∞ Average rate charged from SEB – Rs. 2 per unit



# Case Study (Contd.)

## ∞ Issues

1. Identify the transactions which qualify as Specified Domestic Transactions'
2. What is the comparable uncontrolled price for sale of power by Unit L to related parties?



THANK YOU

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