CONTRIBUTION RECEIVED FROM RSM ADVISORY SERVICES PTE. LTD (INDIA)

Contributed by Sanjay Kapadia / Samir Kanabar, Chartered Accountants
RSM Advisory Services Pte. Ltd.

1. INTRODUCTION

1.1 One of the most daunting tasks faced by Multinational Enterprises (MNEs) today is determining the prices at which goods, services, and technology are traded between Associated Enterprises (AEs) within the group. Since companies within the group are dispersed across different geographical locations, each of them is subject to the domestic laws applicable to their respective countries. Further, more and more countries are realizing the importance of such transactions and have therefore tried to ensure strict adherence to transfer pricing regulations.

1.2 Over the past decade, India has witnessed a series of liberalization coupled with opening up of the economy to foreign investment in a wide array of sectors, prominent among which, are infrastructure, services, etc. Since then, various MNEs have set up their business presence and also expanded its business portfolio / profile in India. Being a developing country itself, the Government has been proactive to enter into Double Taxation Avoidance Agreements with several developed and developing nations to facilitate trade, commerce and other business issues.

1.3 As part of on-going reforms, the Indian government introduced Transfer Pricing Regulations ('TPR') in India vide Finance Act, 2001. Since then, there is no looking back; the revenue authorities have tried to curb the erosion of Indian tax base and have successfully inserted suitable provisions in the Income-tax Act, 1961 ('IT Act').

1.4 Just to give you a brief preview of the framework of the Indian TPR; it prescribe five methods for determining the arm's length price viz. Comparable Uncontrolled Price Method (CUP Method), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM) and Transactional Net Margin Method (TNMM). Further, principles set forth in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995 (OECD Guidelines) form the basis for the Indian TPR. The Rules embodied under the Indian TPR do not distinguish between traditional transaction methods and transactional profit based methods.

2. RATIONALE

2.1 The concept of establishing comparability is central to the application of the arm's length principle. An analysis under the arm's length principle generally requires information about AEs involved in the controlled transactions, the transactions at issue, the functions performed and the information derived from the independent enterprises engaged in comparable transactions or business.

2.2 The arm's length principle operates on the premise that AEs are independent of each other in their commercial and financial relations and the transactions between them are to be free from any conditions, which could be imposed because of such relationship.

2.3 The objective of comparability analysis is always to seek the highest practicable degree of comparability recognizing that there will be unique transactions and cases where any applied method cannot be relied or even applied for that matter. Needless to say, the closest approximation of the arm's length price will be dependent on the availability and reliability of comparable data.

3. OUR COMMENTS

3.1 We have perused the issues raised by the Working Party No. 6 of the OECD Committee on Fiscal Affairs. Our comments on each of the identified issues follow, and are after taking into consideration the practical issues faced by us while assisting / advising clients in complying with the Indian TPR. We have used illustrations at appropriate places to elucidate our comments under each of the issues raised by the Working Committee.

3.2 While commenting, we have been guided with the fact that the focus is more on the guidance that needs to be incorporated into the OECD Guidelines to address the practical issues faced by companies / advisors while identifying appropriate comparables, analyzing the same and adopting ***External comparables*** as against ***Internal comparables***.

3.3 Para 3.43 of the OECD Guidelines *inter alia* state as follows:

"The AE to which the transactional net margin method is applied should be the enterprise for which reliable data on the most closely comparable transactions can be identified. This will often entail selecting the AE that is the least complex of the enterprises involved in the controlled transaction and that does not own valuable intangible property or unique assets."

For the sake of simplicity and to avoid unnecessary duplication, we have termed the AE that is selected for analyzing the applicability of a method as ***tested party***. This concept has been widely used in several of our illustrations.

4. COMP 1

4.1 **Requirement to perform an analysis of *transactions* vs. an analysis of third party information gathered at company level**

DESCRIPTION: All OECD transfer pricing methods, whether traditional or profit based methods, are transactional methods. In practice, third party information is not often available at transactional level. Can third party data at company level meet the arm's length standard and if so under what conditions and to what extent? Should existing guidance in paragraph 1.42 of the Guidelines on combined transactions be extended to provide guidance on aggregated third party transactions?

4.2 **Our Comments**

4.2.1 It is a known fact that having regard to the limited availability of information in public domain, it is almost impossible to obtain third party information at a transactional level. In this regard, we discuss hereunder the problems faced by companies (wherever necessary using the Indian perspective) while examining comparability under each of the prescribed methods:

<u>*CUP Method*</u>

This method is ideally suited for commodities, which are the subject matter of frequent trade in the open market. In such cases, the prices of commodities prevalent in the market may serve as a benchmark for substantiating the arm's length principle. However, with respect to intermediate or capital goods, a difficulty could arise, since information regarding market prices of the same may not be readily available.

- ***Data compiled and maintained by other Regulatory Authorities***

An issue that needs to be addressed here is the reliance that one could place on such data for substantiating the arm's length principle. A typical example could be the database maintained by the Customs Authorities, which may contain aggregate figures of products / commodities imported / exported during a specified period. In the Indian context, such data is available with respect to import / export of merchandise through all recognized sea ports, airports and land customs stations in India. The details contained therein reflect the quantum and value of products / commodities (CIF value) both imported into and exported from India respectively and the country from / to which the product is imported or exported respectively.

However it needs to be kept in mind that, this database does not *inter alia* disclose following key information, which may be absolutely critical while identifying uncontrolled prices of products, viz.

- Whether the transacting parties are AEs - In such a case, it is absolutely impossible to demarcate the prices for products traded between AEs and unrelated entities.
- Specifications relating to quality of a product - Details regarding the quality of a product may have a significant impact on its transaction value. Lack of sufficient information in this respect casts doubts on the accuracy of considering prices reflected in the databases as uncontrolled.
- Terms and conditions - An essential determinant of the price of a product is the terms and conditions on which the transaction (involving the product) has been crystallized. For e.g. where the credit period differs between two transactions, appropriate adjustments are needed to make them comparable.

The Revenue Authorities may not ignore such data and could consider the same as secondary / supplementary data to substantiate the arm's length result determined through the primary method.

- ***Financial Statements of Companies***

Financial statements of companies are an essential source of information. Generally, corporate laws provide for company disclosure of details relating to the purchase / consumption of raw materials, and sales of finished goods. The details disclosed in this regard may contain information of the products dealt with by the company. It is likely that a company dealing in a variety of products may disclose each of them under their generic names. Therefore, it is practically difficult to identify details of a specific product if the same is reflected under its generic name.

Further, such statements do not disclose the following key parameters, which are vital for establishing comparability:

⊖ Quality specifications;

⊖ Terms of delivery i.e. FOB / CIF;

⊖ Details regarding quantity discounts given;

⊖ Credit period (Interest charged thereon), etc.

As mentioned earlier, each of the above factors is critical for determining the price of a comparable product. As is the case with the Customs database, one is not in a position to delineate the price of a specific product sold / purchased to / from an AE and an unrelated entity.

- ***Price Quotes***

Having regard to the way business is generally transacted, companies (intending to purchase a specific commodity), very often obtain quotations from potential suppliers before zeroing in on a given supplier. These quotations contain rates quoted by a supplier for supplying a particular product. Presuming that the quotations are obtained from independent third parties, can the rates contained therein be used as reliable uncontrolled data vis-à-vis the products covered therein?

Presently, the OECD Guidelines are silent on the acceptability of quotes as valid external comparables. Suitable guidance in this regard would be gladly accepted. These quotes could serve as valuable secondary data to support the primary method employed to determine the arm's length price. Further, the tested party could also retain these quotes to substantiate its efforts to procure comparable uncontrolled data.

- ***Published Information***

There are several analyst reports available in public domain, which provide information regarding sales prices, etc. Various trade associations also publish similar information.

However, the above information does not include specific contract details, including whether the same is between related parties, etc. Further, such data also does not provide the terms and conditions and the risks assumed. Accordingly, it is not known whether the published rates can be regarded as uncontrolled comparable transaction rates. Further, such reports do not indicate the source and reliability of such rates.

Having regard to the degree of accuracy required in conducting the functional and comparability analysis and the fact that there is no authenticity of data published in the reports (since the source of data is not available), such data cannot be considered as a reliable comparable.

We would appreciate if the OECD Guidelines takes cognizance of such sources of data available in the public domain and clarify the relevance of the same with respect to the arm's length principle. It would also be of great relevance, if OECD issues appropriate guidelines specifying the criteria for considering the applicability of the said data. While doing so, the OECD may consider the limited availability of information in developing economies as against developed economies. Further, one must also take into account that a sizeable portion of trade today is between developed and developing countries. Therefore, recognizing and filtering the available sources of information may go a long way in assisting companies operating in developing countries to comply with the arm's length principle.

The OECD Guidelines could also emphasize the importance that should be placed on such supplementary data by Revenue Authorities.

CPM / RPM

Application of RPM / CPM requires a comparison of gross profit mark-up earned by the tested party (from the international transaction) with similar margins earned by comparable companies in similar situations. However, in practice it is difficult to arrive at the gross margin of the comparables unless it is mandatory under the GAAP followed to disclose such gross margins. Currently, under the Indian GAAP, it is not mandatory for Indian companies to disclose the gross profit from business operations.

In fact, many a times, either of these methods may be appropriate; however the practical difficulty encountered in its application is instrumental in rejecting the method.

TNMM

Generally, TNMM is used when direct comparables are not available. This is because, TNMM is an indirect method whereby, the operating profit margin realized by an enterprise is related to some key factor such as sales, costs, net assets, etc. and the ratio so computed is compared to the operating margin realized by an unrelated enterprise from a comparable transaction.

Having regard to the nature of functions performed and the limited availability of information, TNMM is generally considered as the preferred method for applying the arm's length principle. Under TNMM, the degree of functional comparability required to obtain a reliable result is generally less than that required under the RPM or CPM since the differences in functions performed are usually reflected in operating expenses.

In light of the practical difficulties faced while examining the applicability of the other prescribed methods, TNMM seems to be the preferred method for justifying a majority of international transactions. Further, the OECD Guidelines currently envisage usage of profit based methods at a transactional level. However, in view of the limited availability of third party data at a transactional level, it would be appreciated if the OECD Guidelines recognize the usage of the same at company level as an appropriate basis for determining the arm's length standard.

4.2.2 ***Aggregation of Transactions***

4.2.2.1 While the OECD Guidelines provide guidance in respect of aggregation of transactions of the tested party, appropriate clarifications with respect to consideration of third party data at company level would be of great assistance. As discussed earlier, it is often difficult to obtain third party information at a transactional level. Following are three typical cases (from an Indian perspective), where aggregate third party data may be resorted to while justifying conformity with the arm's length principle:

- Owing to the broad spectrum of transactions executed into within an MNE group, there are bound to be few transactions, which are unique. A typical transaction would be the payment of royalty by a company (tested party) to its overseas parent. In the instant case, the tested party does not have any other international transaction (other than the payment of royalty). In such a case, TNMM could be the preferred method having regard to the unique nature of the transaction and limited information available in public domain. Consequently, one would consider the margin earned by the tested party from its entire business activity and benchmark the same against similar margins earned by third parties (engaged in similar business activities). This approach may seem rather subjective but most practical.

- With the publishing of segmental accounts now being made mandatory for certain classes of companies in India, those engaged in a variety of business activities need to prepare segmental accounts. Say, for example, an entity (tested party) has entered into an international transaction, which is similar to that entered into a third party. Further, similar transactions entered into by the third party are classified into a separate segment. Since it would be practically impossible to gather information regarding profit margin earned by the third party from each such transaction (i.e. similar to the one of the tested party), it seems prudent to consider the margin earned by a company from that particular segment, which is engaged in activities similar to the transaction of the tested party. Needless to say, segmental accounts reflect the margin earned by a company after aggregating transactions relating to a particular business line.

  Currently, there is no clear guidance in the OECD Guidelines as to the manner of dealing with such situations. Hence, it would be appreciated if the OECD Guidelines recognize the usage of segmental accounts of comparable companies (i.e. at company level), wherever available, as an appropriate basis for determining the arm's length standard.

4.2.2.2 Aggregation of transactions would also be based on the functions performed or based on the functional analysis of the transactions. For instance, in a case where the tested party imports various types of products from its AEs and resells the same under a distributorship arrangement, it would be relevant to establish the arm's length result by justifying the operating profit margin / commission earned by the tested party from the distribution activity. In this regard, each transaction does not have to be tested separately against the arm's length principle. It is acceptable to test together all the conditions that are applicable to the entire product range.

Currently, Para 1.42 of the OECD Guidelines recognize that there are some transactions, which are so closely linked that they cannot be evaluated separately. This would be applicable while pricing a range of closely linked products, when it is impractical to determine the pricing for each individual product i.e. transaction. However, the OECD Guidelines need to emphasize more on the functions performed rather than the products being dealt with by the tested party while providing guidance in respect of aggregation of transactions.

5. COMP 2

5.1 *Need to rely on transactions that took place between independent enterprises*

DESCRIPTION: Should information on third party enterprises that are part of another MNE group and as such engaged in controlled transactions with associated enterprises be systematically rejected, or should such information be regarded as providing useful information and, if this is the case, to what extent? Should existing guidance in paragraph 1.70 of the Guidelines be clarified / developed?

5.2 *Our Comments*

5.2.1 Para 1.70 of the OECD Guidelines explicitly states as follows:

"*It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met.*"

5.2.2 We believe this is a practical issue, which one needs to address, while carrying out comparability analysis for determining the arm's length price.

5.2.3 Generally, companies having subsidiaries are required to publish consolidated accounts and disclose dealings with related parties in a separate schedule. This has a direct nexus to the availability of third party data (in the context of the transaction being analysed), which may be vital for examining comparability.

5.2.4 ***Companies having minimal related party transactions***

In this case, where the related party transactions entered into by the third party are minimal, it would be prudent to apply a benchmark, wherein companies having related party transactions aggregating to a specified percentage (of turnover) could be eliminated. Determining a benchmark in this regard would be absolutely critical, as it would imply that so long as a company does not have related party transactions in excess of the prescribed limit, the data of the company may be treated as uncontrolled and therefore comparable.

5.2.5 ***Companies having substantial transactions with affiliates***

In this case, since substantial related party transactions have been entered into, it would be advisable to consider the consolidated accounts. Preparation of consolidated accounts eliminates the mark-up that may be factored into the transactions between the holding and subsidiary companies. Consequently, what is finally reflected is the true profit margin of the Group as a whole. Therefore, where consolidation is mandatory, consideration of consolidated profit margins could be regarded as an appropriate practice.

5.2.6 Presently, the OECD Guidelines are silent on treatment of comparable data under each of the aforesaid scenarios. We would appreciate if suitable guidance either in the form of clarifications or illustrations are incorporated.

5.2.7 The OECD Guidelines should also recognize the fact that the industry trend is largely determinative of the way companies operate in a specified jurisdiction. Further, the OECD Guidelines should also recognize pronouncements made by tax legislations of various countries. These pronouncements could serve as benchmarks against which, profits of an enterprise could be compared.

5.2.8 In this regard, it may be pertinent to note that ***Section 1.482 - (1)(f)(2)(i)*** of US Regulations regards intra-group transactions as comparable if the transactions entered into between the tested party and its affiliates are similar to the transactions between the independent parties and its affiliates.

6. COMP 3

6.1 *Need to obtain third party information relevant to the review of the five comparability factors*

DESCRIPTION: Can taxpayers obtain sufficient public information on third parties that are potentially comparable in order to review them in light of the five comparability factors? How do taxpayers deal with the practical issues they encounter in this respect?

6.2 *Our Comments*

6.2.1 Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with an uncontrolled transaction. In determining the degree of, including what adjustments are necessary to establish it, an understanding of how unrelated enterprises evaluate potential transactions is a must. This is a practical issue that one is confronted with while examining third party comparable data.

6.2.2 As per Section C of Chapter I of the OECD Guidelines – The Arm's Length Principle, the factors which are relevant to comparability are as under:

- Characteristics of property transferred or services provided;
- Functions performed by the parties;
- Contractual terms;
- Economic circumstances; and
- Business strategies.

6.2.3 Since the Indian TPR is aligned with the OECD Guidelines, the comparability factors enshrined therein are more or less similar to those stated above viz. characteristics of property transferred or services provided, functions performed (having regard to assets utilized and risks assumed), contractual terms and market conditions. Further, Indian TPR also requires one to make reasonably accurate adjustments to the uncontrolled international transaction so as to make the same comparable with that of the tested party.

6.2.4 The practical difficulties faced by us while examining each of the aforementioned factors are individually analyzed as under:

6.2.4.1 <u>*Characteristics of property transferred or services rendered*</u>

This aspect of comparability would be relevant only where the CUP Method is to be applied vis-à-vis the transfer of property or services. Since CUP Method requires higher comparability in respect of transfer of tangible / intangible property or services, it is not possible for us to gather sufficient information to ensure that the product / service of the tested party and that of the comparable is similar in all respects.

One of the most important attributes of property transferred, which has a significant impact on the price of the transaction, is the **quality** of the property transferred. Since almost every company sets its own quality standards internally, the cost of the product sold by that company would differ from a similar product sold by a comparable company, which does not maintain as stringent quality control standards as that of the tested party. Further, since the difference in quality is not readily quantifiable, the subjectivity involved in making reliable assumptions may be prone to litigation by the Revenue Authorities in India.

Another practical issue, which needs to be addressed is the weightage attributed to a brand. Let us consider the following illustration:

A pharmaceutical company, being part of an MNE (tested party) often carries out research on behalf of its overseas affiliates. In such a case, the margin earned by the tested party is benchmarked against companies, which *inter alia* include those with varying degrees of brand value.

The OECD Guidelines are currently silent on the quantification of intangibles. Suitable guidance in this regard would be welcome.

6.2.4.2 *Functions performed by the parties*

The functions performed, assets utilized and risks assumed by the contracting parties play a significant role in determining the profit that each of them should make vis-à-vis the specific international transaction executed by the two parties. Economically significant activities and responsibilities undertaken by the associated and independent enterprises are to be identified and compared in order to determine whether the uncontrolled and controlled transactions are comparable.

The above functional and economic analysis can be carried out only when there is adequate data about comparable companies. However, it is impossible to gather sufficient information regarding key functions performed by the third party and its contracting party, having regard to the assets utilized and risks assumed.

While the functional analysis of the tested party determines the characterization of the tested party i.e. whether it is operating as an ***entrepreneur*** or a ***contract service provider***, there is insufficient information to decipher the same regarding comparable companies. This may be vital in determining the return that the entities should earn and more importantly, whether the two entities are comparable.

Risks are largely dependent on the functions performed. Therefore, companies operating as entrepreneurs would be exposed to a greater risk as compared to the risks assumed by contract service providers. In this regard, the OECD Guidelines could highlight the need to distinguish between an entrepreneur and a contract service provider based on the functional and economic analysis of the tested party. As regards identification of comparable companies, it is not prima facie evident whether companies are entrepreneurs or contract service providers. Therefore, in actual practice, due to lack of sufficient information available in public domain, one generally focuses more on quantitative and qualitative screening criteria for selecting the final set of comparable data.

6.2.4.3 *Contractual terms*

Generally the conduct of the contracting parties are a fall-out of the terms of the contract. As such, an analysis of contractual terms would form part of the functional analysis. Where the terms of the arrangement between the two parties are not explicitly defined, the same has to be deduced from their conduct or economic relationships. However, due to lack of information regarding the contracts entered into between third parties and their respective contracting entities, an essential aspect of comparability goes unexamined.

6.2.4.4 *Economic circumstances*

Market prices for the transfer of same or similar property may vary across different markets or geographical locations owing to the differential costs prevalent in the respective regions. In such cases, it becomes imperative to ascertain the prices that would be prevalent in a market where both, third parties and AEs operate. There are a number of factors which play a key role in determining the price of a product across different geographical locations viz. size and competition in the market, level of demand and supply, availability of substitute goods, etc.

A typical example of an industry where economic circumstances play a key role in a transfer pricing analysis, would be the pharmaceutical industry, where the prices of bulk drugs and formulations are generally regulated by an independent association / legislation.

Further, there may be cases where the tested party is an Economic Oriented Unit (EOU), thereby subject to beneficial provisions under the income tax laws. Therefore, ideally comparables should be companies enjoying similar privileges and engaged in similar activities as that of the tested party. Currently, there is no clear guidance on the treatment of transactions subject to differential tax treatments by different entities viz. tested party and third party.

6.2.4.5 *Business Strategies*

Strategies relating to new product launches, market penetration or expansion of market share may require selling products cheaper and thus earning lower profit in anticipation of increased profits in the future. Such strategies must be taken into account while determining the comparability of controlled and uncontrolled transactions.

Based on the above, it would be prudent to eliminate start-up companies, where the tested party is an established company with years of proven track- record. Start-up companies would be prone to incurring losses during their gestation period. One of the major reasons why start-up companies incur losses may be attributed to its marketing penetration strategy, wherein prices of its products would intentionally be priced below those of competitors in the same industry.

Now let us consider another illustration involving a supply and installation contract. In this case, a contractor is engaged to supply, install and maintain equipment. As regards the supply component, the contractor imports the equipment and resells the same at cost / loss / minimal margin. However, typically, in these kinds of contracts, the contractor expects to earn a margin by charging separate installation fees and entering into long term maintenance contracts.

Say, there is a company, which imports equipment from its overseas affiliate and resells the same to customers in the domestic market. This is done as part of an overall contract of supply and installation typically; the Company installs the equipment for a separate fee. Many a times, the Company resells the imported equipment at cost but compensates for the same by way of increased earnings through after sales services and maintenance contracts.

Suitable guidance in the OECD Guidelines by way of illustrations depicting treatment of the same would be appreciated. In particular, guidance is requested also whether the revenue received by the company on the resale of imported equipment would need to be justified separately or whether it could be clubbed with the annual maintenance contract fees and after sales charges that it proposes to recover in due course.

6.2.5 In light of our above discussions, one may conclude that each of the five comparability factors assume varying degrees of importance depending on the method proposed to be applied for justifying the arm's length principle. The same is summarised in the table below:

CHARACTERISTICS	CUP	RPM	CPM	PSM	TNMM
Characteristics of property transferred or services provided	✔	✔	✔	*X*	*X*
Functions performed by the parties	✔	✔	✔	*X*	*X*
Contractual terms	✔	✔	✔	*X*	*X*
Economic circumstances	✔	✔	✔	✔	✔
Business strategies	✔	✔	✔	✔	✔

6.2.6 Having regard to the relevant importance of each of the five comparability factors vis-à-vis the prescribed methods, suitable guidance should be incorporated in the OECD Guidelines so as to assist in examining uncontrolled data in light of the comparability factors, with respect to the chosen method.

Further, owing to the stringent comparability standards envisaged for the traditional methods and the limited availability of information to establish the same, profit based methods have gained immense practical mileage in many developing economies including India.

7. COMP 4

7.1 ***Need to ensure objectivity of the list of external comparables***

DESCRIPTION: Is it desirable / possible to ensure that potentially relevant external comparables are not excluded either because of the application of a too drastic comparability standard, or because of "cherry-picking" third party information?

7.2 ***Our Comments***

7.2.1 As discussed earlier, comparability analysis is needed to ensure that any adjustment would achieve the results that would have been realized by an independent enterprise in comparable transactions. Therefore, it is imperative to ensure that potential comparables are closely akin to the tested party in all respects. In an attempt to do so, one is guided by the principles of best practices while deciding the selection and screening criteria.

7.2.2 The first step towards identification of comparable data would be deciding the various sources from which comparable data may be procured. Most of the times, one takes recourse to the commercial databases available in public domain to procure the desired information. Having selected the database, one is required to examine the search and selection criteria supported by the said database and its relevance to the transfer pricing analysis.

7.2.3 Once the search criteria are defined, the database retrieves the desired information about the companies included under the specified search criteria. In case the desired data is not available, one could also widen the search criteria to include a broader range of comparables. In such a case, sufficient care has to be taken while arriving at a trade-off between the accuracy of comparables required and the limited information available in public domain.

7.2.4 Next step involves screening of comparable companies. Since there is no clear guidance on the screening criteria to be employed, the same is modified on a case-to-case basis. Broadly speaking, the screening criteria may either be qualitative or quantitative (discussed later).

7.2.5 Having regard to the comparability factors envisaged in the OECD Guidelines, (to bridge the comparability of international transaction with uncontrolled transactions), the following ***elimination*** criteria may included in the OECD Guidelines:

Quantitative Screening

a. Companies having data beyond a stipulated period

b. Persistent loss-making companies – In this regard, reference may be made to the industry trend in which the companies operate. If the industry is such that companies are operating on very small margins, then companies making losses (not abnormal) could be considered for final analysis.

c. Companies not satisfying the turnover limit

- Lower Limit to eliminate start up companies, companies small in size and which have insignificant revenues;
- Upper Limit to eliminate companies big in size.

Let us elucidate this criterion with the following illustration:

X Co (tested party) has total income aggregating to USD 500 million. In such a case, comparable companies having total income between USD 250 million and USD 750 million are only considered as potentially comparable companies. The other companies may either be too small or too big to facilitate a realistic comparison. The determination of this range is rather subjective. Therefore, stipulation of suitable benchmarks (based on the turnover of the tested party) in the OECD Guidelines would be appreciated.

d. Companies not engaged in similar business activity – Where substantial portion of revenue is attributed to business activity dissimilar with that of the tested party.

Qualitative Screening

a. Eliminate companies having controlled transactions - based on related party disclosure

b. A company need not be eliminated if its consolidated accounts are available and related party transactions are only with subsidiaries as the transactions get squared off

c. Review annual reports & disclosures made by directors in Management Responsibility Statement to suit the comparability criteria

d. Unusually high / abnormally low growth rate (compare revenue growth over last 3-4 years)

e. Inconsistent revenue recognition policy

7.2.6 As can be seen from the above, each of the companies goes through a scientific screening process. Accordingly, the chances of any intentional elimination or inclusion of companies are totally eliminated. Let us consider the following illustration to elucidate the unbiased nature of the screening criteria:

Elimination of companies, which have sales turnover / total income below an arbitrarily defined range. This range is decided based on the turnover / total income of the tested party. Accordingly, companies falling within the pre-defined range would be considered for further analysis. If the adoption of the said criteria does not result in any companies, the search could be further broadened. This would evidently result in companies, which were eliminated either because their turnover / total income was short of the specified range or those, whose turnover / total income exceeded the prescribed range.

7.2.7 Therefore, since broadening of the search criteria does not involve intentional elimination or inclusion of companies, the question of ***cherry picking*** companies may not arise.

8. COMP 5

8.1 *Determination of the years to be covered and use of multiple year data*

DESCRIPTION: It is often the case in practice that taxpayers rely on previous year data to determine future transfer pricing, because third party information is only published after the year end. How do taxpayers deal with this issue? Please comment on retroactive adjustments and use of multiple year data.

8.2 *Our Comments*

8.2.1 Based on our understanding, the issue being addressed here is the usage of uncontrolled third party data of a previous year to substantiate the pricing policy to be instituted for the next year.

8.2.2 Since the performance of companies operating in the same industry as that of the tested party is indicative of the earnings of the tested party, benchmarking profits of the tested party with those of comparable companies could be considered as a starting point to establish future transfer pricing policy. An interesting point that needs to be noted is that previous year financials of comparables are used to benchmark pricing policies of the tested party for the subsequent year. It is relevant to mention here that the Indian TPR provides for usage of data upto preceding two years to determine the arm’s length price.

8.2.3 Many a times, companies intend to set their pricing policy at the beginning of the year. This would necessitate compilation of third party data for the said period as well. However, since the third parties generally publish their accounts at the year -end, one is compelled to benchmark profits of the company with the latest available third party data. Having said so, one must take cognizance of the specific conditions that existed at the time for which financials of third parties are available.

8.2.4 While devising transfer pricing policies for companies, it is imperative to take *inter alia* cognizance of the following:

- Identification of closest comparables;
- Contractual terms and conditions between AEs;
- Industry trend / outlook; and
- Cost attributes / components viz. human resource, infrastructure, technology, telecom, marketing, selling and distribution expenses, etc.

8.2.5 Each of the above factors is equally important while benchmarking the margins / prices of the tested party. However, a special mention must be made of ***cost components*** considered for tested party vis-à-vis that considered for comparables. Appropriate adjustments are required where material differences are significant enough to affect the earnings potential of comparable companies.

8.2.6 The factors that play an important role while carrying out the comparability analysis need to be examined in detail while considering data during the preceding two years. An example could be the ***impact of any significant event*** (which occurred during the year for which financials of comparables have been considered e.g. September 11 attack, which affected the bottom lines of several companies). In such a case, either data for that particular year would not be considered for comparability analysis or appropriate adjustments need to be made to ensure that the companies being compared are functioning in a similar environment.

8.2.7 Another factor that needs to be considered is the adjustment on account of ***inflation***. Since the prices of commodities / services are bound to undergo a change on account of inflation either by virtue of an express clause in the agreement (if any) or by virtue of a re-negotiation based on commercial dealings, an adjustment may be required.

8.2.8 Having regard to the subjectivity involved in the usage of previous year data for future transfer pricing, it would be appreciated if the OECD Guidelines could clearly stipulate the factors, which need to be considered while considering previous year data. Having done so, the OECD Guidelines could also illustrate a rationale / basis for making retroactive adjustments while using multiple year data.

9. COMP 7

9.1 *Definition of comparability adjustments where they are appropriate*

DESCRIPTION: Should further guidance be developed on comparability adjustments, e.g. when to perform which adjustment, and how? How to determine whether adjustments are reliable enough to satisfy the arm's length principle? How to deal with cases where numerous or highly sophisticated adjustments are performed to information on uncontrolled transactions that may not prima facie satisfy a very high standard of comparability (e.g. due to difficulties in obtaining information on the five comparability factors)?

9.2 *Our Comments*

9.2.1 A comparability analysis is needed to ensure that any adjustment would achieve the results that would have been realized by independent enterprises in comparable circumstances. Without adequate comparability, the third party data used may not present a true market price because of the differences in the third party vis-à-vis the tested party.

9.2.2 Comparison involves conditions relating to transactions (between independent enterprises and between AEs) and also activities of enterprises. The difference should not materially affect the price in the open market; if it does so, reasonable accurate adjustments should be made to eliminate the material effects of such differences. In actual practice, rarely are uncontrolled transactions sufficiently similar to controlled transactions so as to constitute comparable transactions; hence the limited usage of traditional methods.

9.2.3 In view of the above, adjustments may be required on account of differences in any of the following:

- Quantitative - Contractual terms viz. terms of delivery / payment, discount, credit period, installation services, etc.

  Adjustments for differences in each of the above contractual terms may be carried out using suitable arithmetical operations. This must be made only so long as the adjustment clearly reflects the differences between the two transactions.

- Qualitative - Quality of the product or property being transferred. Since adjustments in this regard are highly subjective, its use should be restricted.

9.2.4 As far as traditional transaction methods are concerned, it is possible to make quantitative adjustments. However, in respect of transactional profit methods, it may be possible to make such adjustments on a case-to-case basis.

9.2.5 Let us elucidate the concept of making quantitative adjustments while applying TNMM with the help of the following illustration:

The tested party is a pharmaceutical company, which manufactures and sells drugs in the local and international market. It carries out an extensive marketing drive to identify customers in the international market. The international transaction being examined here is the sale of drugs to overseas affiliates. TNMM has been selected as the preferred method for determining the arm's length price. Thereafter, a search for comparable companies engaged in the manufacture and sale of drugs was sourced from commercial databases.

The financial results of the final set of comparable companies indicate that none of them incurred substantial marketing costs as compared to the tested party. In such a case, it would be prudent to make an adjustment for the marketing costs incurred by comparable companies while arriving at their respective operating margins and compare it with the similar margin earned by the tested party (not considering the marketing costs).

9.2.6 Currently, there is no explicit guidance within the OECD Guidelines on the manner of making adjustments (both quantitative and qualitative) when using transactional profit methods. Clarifications using above or similar illustrations would be appreciated.

10. COMP 8

10.1 *Interpretation and use of data collected*

DESCRIPTION: Diverging practices exist on the definition of the arm's length range and use of statistical tools. Do you consider the range should include all the data obtained or should the extreme results be excluded? Should the top and bottom of the range be systematically removed (e.g. by using an inter-quartile or similar type of range)? How should loss-making comparables be dealt with?

Should the answers to these questions be different depending on the "quality" of the comparables (e.g. in cases where a less stringent comparability standard would be applied by a taxpayer operating in a highly integrated business where it is very difficult to find independent comparables that fully satisfy the existing comparability standard)?

10.2 *Our Comments*

10.2.1 Yes, diverging practices do currently exist on the definition of the arm's length range and use of statistical tools. Due to lack of guidance currently available in the OECD Guidelines, many countries have prescribed use of specific statistical tools to arrive the arm's length price / margin for a range of companies.

10.2.2 The Indian TPR provides that where more than one price is determined (i.e. there is a range of data from which the arm's length price is to be determined), then the arm's length price shall be the arithmetical mean of such prices. Further, the highest Indian Tax Authority, the Central Board of Direct Taxes has issued instructions introducing the range concept ($\pm$5%) whereby, the transaction value could vary from the arithmetical mean, by an amount not exceeding 5% of such arithmetical mean. Likewise, the US Regulations prescribe use of quartiles and inter-quartiles to arrive at the arm's length price.

10.2.3 As discussed earlier, while screening companies to arrive the final set of comparables, reference may be made to the general trend of the industry including the business strategies and the segments prevalent in the industry. Abnormal items featuring in the profitability statements of comparables need to be disregarded while determining the arm' s length price as the same would vitiate the true results of the company. More so, the tested party would not have been subject to similar conditions in which case a realistic comparison is not possible.

10.2.4 Further, the history of companies need to be examined to ensure that the profits for the year under consideration are not vitiated by any extraordinary events viz. strike, lockout, etc. Further, if the track record of companies reveals that they are making consistent losses, margins of the same cannot be regarded as strict comparables. Detailed understanding of the industry may also be instrumental in either including or eliminating loss-making companies. As explained earlier, if the industry is such that all companies operate on a minimal margin, then it may be prudent to consider loss-making companies as part of comparables. However, where companies within the industry are known to make enormous profits, loss-making companies may not be considered in the final analysis.

10.2.5 Filtering comparables identified vide the search process is absolutely critical; therefore, one should focus more on qualitative analysis as a benchmark for selecting / eliminating companies as the same would result in a realistic assessment of potential comparable companies. Thereafter, one may proceed with the determination of the arm's length price based on the domestic regulations of the respective countries.

10.2.6 Currently, the OECD Guidelines are silent on the consideration of the entire range of data to determine the arm's length price. Suitable clarifications in this regard would be welcome.

11. COMP 9

11.1 *Specific comparability issues when applying transactional profit methods*

DESCRIPTION: Interestingly, taxpayers often explain recoursing to profit methods as a means to overcome some of the issues that arise in practice with respect to traditional methods. Concerning the use of the transactional net margin method, it is often argued that a net margin approach is less sensitive to some of the discrepancies that may exist between the controlled transaction and the third party transactions being compared – for instance net margin indicators are less sensitive to differences in accounting standards as well as to some differences in products or functions. As far as the transactional profit split methods are concerned, it may be particularly difficult to obtain external market data on profit splits achieved by independent parties and in practice this difficulty often leads taxpayers to implement a profit split method without such external comparable data – some taxpayers in fact argue that using a profit split method is a solution to the lack of external comparable data.

In your opinion, is there a need to develop further guidance on specific comparability issues in the context of profit methods? Please comment on both the transactional net margin method and the transactional profit split methods.

11.2 *Our Comments*

11.2.1 The transaction profit methods tend to focus on a broad segmentation of functions performed rather than on a fine analysis of each transaction or product as is done under traditional methods. Contrary to what is actually intended, many of the international transactions undertaken today by MNEs are justified using TNMM (being a residual method). This is mainly on account of the limited information available in public domain.

11.2.2 Operating profit margins take into account the operating income of companies disregarding the extraordinary items peculiar to the specific company.

Para 2.39 of the OECD Guidelines recognize the difficulties that may arise due to varied accounting disclosure requirements of comparable companies. Accordingly, operating profit margins of comparable companies could be used while applying CPM. This seems to amplify the fact that TNMM is nothing but an extension of CPM.

11.2.3 Profit Level Indicators (PLIs) are widely used in conjunction with TNMM. They may be either based on the balance sheet or income statement.

The Balance Sheet based PLIs (e.g. Return on Assets / Return on Capital Employed, etc.) are considered as most reliable if the level of tangible operating assets play a greater role in generating operating profits and has a high co-relation to profitability. For e.g. a manufacturer's operating assets, such as, property, plant and equipment could have more impact on profitability than a distributor's operating assets.

We also understand that reliability of Balance Sheet based PLIs would depend on the structure of taxpayer's, tangible assets and their similarity to those of comparables, since different asset categories can have different rates of return. Further, use of intangibles, which contribute substantially to the operations of the company, could also distort the picture since these are kept out of the asset base. Generally, purchased intangibles are reflected in the books of accounts, whereas internally developed intangibles remain out of the books.

On the other hand, the Income Statement based PLIs (e.g. Total costs / Total income, etc.) require a closer functional comparability to achieve a reliable measure of an arm's length result as against that required under the Balance Sheet PLIs. This may be on account of the following reasons:

- Operating costs have a significant impact on its pricing and hence, have a direct nexus to its profitability;
- Assets play a lower role in generating operating profits;
- It is an industry practice to set prices by reference to cost;
- Non-availability of data / information for making accurate and reliable adjustments to the asset base (viz intangibles, assets provided by customers, owned assets v/s leased assets) of comparable companies while applying asset based PLI;

11.2.4 Presently, the OECD Guidelines are silent on the selection and usage of an appropriate PLI for different types of companies. Suitable guidance in this regard would be gladly accepted. ***Section 1.482-5 (b)(4) of the US Regulations*** recognizes the importance of PLIs and accordingly, discusses its usage under a number of scenarios.

11.2.5 From an overall perspective, the OECD Guidelines specifically cater to issues encountered while justifying routine transactions. Having regard to the wide array of transactions executed between AEs in today's world, the OECD Guidelines could take into consideration the complex nature of transactions while providing guidance either by way of clarifications or illustrations. Further, this would also help companies in defending their transfer pricing policies before the Revenue Authorities.

11.2.6 Some typical transactions which could be addressed in the OECD Guidelines are as follows:

- Sale or purchase of assets / shares;
- Corporate services being rendered by the parent company;
- Payment of royalty, etc.

11.2.7 Recognition of PLIs and illustrations elucidating the treatment of unique transactions may help change the current preference of traditional methods over transactional profit methods as envisaged in the OECD Guidelines. This would bring all the methods on par and help substantially in justifying the arm's length principle.

12. OTHER ISSUES

12.1 *Use of Secret Comparables*

12.1.1 There is considerable concern expressed by companies over data collection by the Revenue Authorities and its confidentiality. Globally, litigation continues over the use of secret comparables by the Revenue Authorities and the need to make appropriate disclosure to the taxpayers.

12.1.2 A secret comparable generally means use of information/data about a taxpayer by the Revenue Authorities to form the basis of transfer pricing scrutiny against another taxpayer. Many developed countries like USA and UK do not use secret comparables in transfer pricing matters. However, countries like Japan, France, China etc have been allowed the use of secret comparables.

12.1.3 From an overall perspective, It would seem rather unfair for Revenue Authorities to use secret comparables against a taxpayer while carrying out a transfer pricing audit. Further, wherever they are being used, the taxpayer should be allowed to obtain full disclosure of such secret comparables along with all information relating to the subject to enable the taxpayer to carry out an independent functional and comparability analysis.

12.1.4 Having regard to the varied approaches adopted by different countries with respect to usage and disclosure of secret comparables, a clear and express provision in the OECD Guidelines regarding the use or otherwise of secret comparable is desirable to have certainty in the matter and to avoid unnecessary litigation.

12.2 *Arm's length price for an entity and overseas affiliate*

12.2.1 Let us examine this issue with the help of the following illustration:

X Ltd, who has paid royalty to its overseas affiliate for usage of certain technology has carried out a separate transfer pricing study and has determined such that royalty payment meets with the arm's length principle. While in the source country, X Ltd. could avail tax break to the extent of the royalty paid, the overseas affiliate would be liable to tax on the same income (source based taxation). Accordingly, both X Ltd as well as the overseas affiliate would each have to substantiate the arm's length principle.

12.2.2 In this regard, it may be relevant to consider the concept of erosion of the tax base, which essentially emphasises that as a result of applying arm's length standard, there should not be any erosion of the tax base. The tax base erosion concept would come into play where there exist differential tax rates. In the above illustration, a higher tax break for X Ltd. would give rise to tax erosion in the source country.

12.2.3 The OECD Guidelines are currently silent on the determination of separate arm's length prices for the same international transaction *qua* both the contracting entities (AEs). Having regard to the rapid expansion of trade between AEs, OECD's viewpoint on the same would be of great assistance, especially while substantiating the arm's length principle of the same transaction for both the affiliates, before the Revenue Authorities.

12.3 *Use of Independent Valuation Reports*

12.3.1 The independent valuer's report assumes tremendous importance in a case where securities i.e. bonds, shares, etc. (of unlisted companies) or fixed assets are transferred *inter se* between AEs. Having regard to the lack of appropriate comparable data at a transactional level, this seems the only available benchmark to justify conformity with arm's length principle.

12.3.2 In respect of intra-group restructuring type of transactions, which could typically involve sale, merger of businesses or assets, an independent valuation could serve as an ideal benchmark for determining the arm's length standard for such transactions. Moreover, since such classes of transactions are gaining increasing importance in today's globalisation era, appropriate guidance commenting on the use of independent valuation reports would be gladly accepted.

12.3.3 Further, the OECD Guidelines could also provide alternate guidance for benchmarking arm's length principle for such typical transactions.