

## Transfer Pricing Adjustments

### Methods of calculating arm's length price:

- Comparable uncontrolled price method
- Resale price method
- Cost Plus method
- Profit split method
- Transactional net margin method

The most appropriate method will be selected for determination of Arm's length price.

If variation between arm length price and price at which international transaction is undertaken is upto 1% of price of international transaction for wholesale trading and 3% of price of international transaction for other cases, then price of international transaction shall be deemed to be arm's length price.

#### ➤ Comparable uncontrolled price Method:

Step1: Determine price charged or paid for property/services transferred in a comparable uncontrolled transaction. (Hamare jaise transaction bazar mai)

*Uncontrolled transaction: A transaction between enterprise other than associated enterprise, whether resident or non-resident.*

Step2: Price determined in step1 shall be adjusted for functional differences between international transaction & comparable uncontrolled transaction. (Hamare transaction ko bazar ke transaction ke hisab se adjust karenge) e.g. After sales support service, Freight & Insurance.

Step3: Now, price calculated in step2 is arm's length price.

#### ➤ Resale price Method:

Step1: Determine price at which property/services are obtained by the enterprise from an associated enterprise & which can be resold to an unrelated enterprise. (Resale price of goods after purchasing)

Step2: Resale price is reduced by normal gross profit accruing to enterprise by purchase/sale of similar goods in comparable uncontrolled transaction. (Hamne jab dusro ko bazar mai becha to kitna kamaya)

If no uncontrolled transaction then gross profit of unrelated person is taken.

Step3: Reduce expenses incurred for purchase of property.

Step4: Price computed in step3 is now adjusted for the functional differences in international transaction & comparable uncontrolled transaction. (Hamare transaction ko bazar ke transaction ke hisab se adjust karenge)

Step5: Price computed in step4 is arm's length price.

➤ Cost Plus Method: (Very Important)

We will start solving question by taking cost (direct & indirect) as our base.

Step1: Determine direct & indirect cost of production of property transferred or services provided to an associated enterprise. (Hamare kya cost hai)

Step2: Determine normal gross profit % mark up on such cost. (If such property/services are transferred to an unrelated enterprise or in comparable uncontrolled transaction) (Ham Bazar mein kitna profit% laga kar bechte hai dusro ko)

Step3: Now, gross profit % determined in step2 is adjusted with functional differences in international transaction & comparable uncontrolled transaction. (Hamare profit% ko bazar ke transaction ke hisab se adjust karenge)

Step4: Cost determined in step1, shall be increased by adjusted profit % of step3.

Step5: Price computed in step4 is arm's length price.

➤ Profit Split Method: (Not used much)

It is applicable mainly in international transactions involving transfer of **unique intangibles or multiple international transaction** which are so interrelated that they cannot be evaluated separately. For the purpose of determining the arm's length price of any one transaction by which-

- 1) Combined net profit of associated enterprise arising from international transaction.
- 2) Relative contribution made by each associated enterprise to the earning of such combined profit.
- 3) Combined net profit is then split into enterprise on the basis of their relative contribution.
- 4) Apportioned profit is taken into account to calculate arm's length price.

➤ Transactional Net Margin Method:

Step1: Net profit margin realized is calculated with respect to costs incurred or sales effected or assets employed by the enterprise for transaction between associated enterprise. (Hamara margin)

Step2: Net profit margin realized by the enterprise or by unrelated enterprise from a comparable uncontrolled transaction having regard to same base. (Hamare jaise transaction ka bahar margin)

Step3: Net profit margin calculated in step2, is adjusted for differences if any between international transaction & comparable uncontrolled transaction.

Step4: Net profit margin of step3, is taken into account to arrive at arm's length price in relation to international transaction.

## Questions from Past Attempts:

### ➤ May23: (6 Marks)

Q. Shahi Pvt. Ltd., a domestic company, located in Special Economic Zone (SEZ) since November 2013. The company is engaged in manufacturing of consumables goods. The manufacturing is- wholly dependent on raw material which is imported from Sumi Inc. of Japan.

The following details are furnished in respect of the financial year 2022-23:

- (i) Shahi Pvt. Ltd. imported goods for 30 crores from Sumi Inc.
- (ii) Sumi Inc. supplied similar raw materials to unrelated parties with a mark-up of 10%, whereas for Shahi Pvt. Ltd. it earned a mark-up of 20%.
- (iii) Shahi Pvt. Ltd. was allowed to use the brand name of Sumi Inc. without any payment and whereas the unrelated parties cannot use such brand name in India. The annual cost of brand value is 90 lakhs.
- (iv) The Assessing Officer referred the matter to the Transfer Pricing Officer (TPO) for determination of Arm's Length Price (ALP).

You are required to answer the following:

- (a) Compute the arm's length price of the transaction and adjustments to be made to the income of Shahi Pvt. Ltd while discussing the relevant provisions.
- (b) If Transfer Pricing Officer (TPO) had enhanced the income of Shahi Pvt. Ltd. by 2 crores, will that enhanced amount of income be eligible for deduction u/s 10AA?
- (c) Will Shahi Pvt. Ltd. become liable for penalty for under-reporting of income based on the report of the Transfer Pricing Officer (TPO)?

Ans. (a) Shahi Pvt. Ltd, an Indian company and Sumi Inc. of Japan, are deemed to be associated enterprises as per section 92A(2), since Shahi Ltd.'s manufacturing is wholly dependent on raw material imported from Sumi Inc. Further, the transaction of purchasing raw material falls within the meaning of "international transaction" u/s 92B. Hence, transfer pricing provisions would be attracted in this case.

<u>Computation of Arm's length price and adjustment to be made</u>	in crores
Price of imported goods charged by Sumi Inc. from Shahi Pvt. Ltd.	30.00
Less: Mark up earned @ 20% [30 crores x 20/120] from Shahi Pvt. Ltd.	<u>5.00</u>
	25.00
Add: Mark up earned in uncontrolled comparable transaction @10%	<u>2.50</u>
	27.50
Add: Adjustment on account of brand value [Annual cost of brand value]	<u>0.90</u>
Arm's length price of raw material purchase	28.40
Less: Price at which raw material was imported by Shahi Pvt. Ltd. from Sumi Inc.	<u>30.00</u>
Adjustment to be made to the income of Shahi Pvt. Ltd.	1.60

(b) Shahi Pvt. Ltd. cannot claim **deduction under section 10AA** in respect of 2 crores, being the amount of income by which the total income is enhanced by the TPO, by virtue of the first proviso to section 92C(4).

(c) No, Shahi Pvt. Ltd. would not be liable for penalty for under reporting of income based on the report of the TPO, since the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer would not be included within the scope of under-reported income under section 270A, assuming Shahi Pvt. Ltd. has maintained information and

documents, as prescribed under section 92D, declared the international transactions under Chapter X and disclosed all material facts relating to the transaction.

➤ Nov22: (6 Marks)

Q. MNO Ltd., Mumbai, is engaged in providing IT and communication services. It is a subsidiary company of MNO Inc., USA. During the previous year 2022-23, MNO Ltd. has provided such services to MNO Inc. and similar type of services were also provided to HTY Ltd., Hong Kong. Billing details and other information are given below:

- (i) Billing per month to MNO Inc.: USD 85,000
  - (ii) Billing per month to HTY Ltd.: USD 92,000
  - (iii) MNO Inc. has given a loan of USD 1,20,000 to MNO Ltd. to purchase hardware for execution of its project. Rate of interest is 4%p.a.
  - (iv) Direct and indirect cost incurred are USD 120 and USD 210 per hour respectively.
  - (v) MNO Ltd. works 9 hours per day for 18 days to execute the projects for MNO Inc. and 8 hours per day for 18 days to execute projects for HTY Ltd. MNO Ltd. has provided such services throughout the year to both the customers.
  - (vi) Warranty was provided to HTY Ltd. for a period of 2 years. Cost of warranty is calculated at the rate of 1.5% of direct cost incurred. The cost of warranty is neither included in the direct nor indirect cost. Assume all the cost and billing are even throughout the year.
- Compute Arm's Length Price as per the cost-plus method and the amount to be added, if any, to the income of MNO Ltd. Assume conversion rate 1 USD = 75.

Ans. Determination of Gross Margin of Comparable Uncontrolled transaction i.e., of HTY Ltd

Particulars	HTY Ltd. (USD)
Direct Cost (USD 120 x 8 hours x 18 days)	17,280
Indirect Cost (USD 210 x 8 hours x 18 days)	<u>30,240</u>
<b>Total Direct and Indirect cost</b>	<b>47,520</b>
Billing per month	<u>92,000</u>
<b>Gross Margin being gross profit</b>	<b>44,480</b>
<b>Gross Margin to cost (%) [44,480 x 100/47,520]</b>	<b>93.60%</b>
<b>Adjustment for functional difference on account of cost of warranty</b>	
Total Direct and Indirect Cost	47,520.00
<b>Add: Cost of warranty [1.5% of direct cost of USD 17,280]</b>	<u>259.20</u>
<b>Total Cost</b>	<b>47,779.20</b>
Billing per month	<u>92,000.00</u>
<b>Margin after cost of warranty being profit margin</b>	<b>44,220.80</b>
[92,000 - 47,779.20]	
<b>Profit margin to cost (%) [after considering functional difference on account of cost of warranty [44,220.80 x 100/47,779.20]</b>	<b>92.55%</b>

Computation of Arm's Length Price by applying Cost Plus Method

	MNO Inc (USD)
Direct Cost (USD 120 x 9 hours x 18 days)	19,440.00
Indirect Cost (USD 210 x 9 hours x 18 days)	<u>34,020.00</u>
Total Direct and Indirect cost	53,460.00
Add: Interest on loan of USD 1,20,000 borrowed for purchase of hardware [USD 4,800 (i.e., USD 1,20,000@4%) / 12]	<u>400.00</u>
<b>Total Cost</b>	53,860.00
Profit margin by applying the margin of 92.55% of total cost of USD 53,860	<u>49,847.43</u>
<b>Arm's length price of billing per month</b>	<b><u>1,03,707.43</u></b>
<b>Arm's length price (in `) [USD 1,03,707.43 x 75]</b>	77,78,057
Actual Billing per month [USD 85,000 x 75]	63,75,000
Income to be added to the total income of MNO Ltd. [77,78,057 - 63,75,000] = 14,03,057 x 12 =	1,68,36,684

➤ May22: (6 Marks)

Q. Alfa Ltd., Australia, holds 30% equity shares in Beta Ltd., India. Beta Ltd. develops software and also provides the related support services. Beta Ltd. during the year billed Alfa Ltd., Australia for 150 man-hours at the rate of 2,500 per man hour. The total cost (direct and indirect) for executing this work amounted to 3,50,000.

However, Beta Ltd. billed Gama Ltd., India at the rate of 3,500 per man hour for the similar level of manpower and earned Gross Profit of 40% on its cost.

The transactions of Beta Ltd. with Alfa Ltd. and Gama Ltd. are comparable, subject to the following differences:

- (i) While Beta Ltd. also derives technological support from Alfa Ltd., there is no such support from Gama Ltd. The value of technological support received from Alfa Ltd. may be put at 15% of normal gross profits,
- (ii) As Alfa Ltd. gives business in large volumes, Beta Ltd. offered to Alfa Ltd., a quantity discount which may be valued at 10% of the normal gross profits,
- (iii) In the case of rendering services to Alfa Ltd., Beta Ltd. neither runs any risk nor incurs any marketing costs. On the other hand, in the case of services to Gama Ltd., Beta Ltd. has to assume all the risks and costs associated with the marketing function which may be estimated at 20% of the normal gross profits,
- (iv) Beta Ltd. offered one month credit to Alfa Ltd. The cost of providing such credit may be valued at 5% of the normal gross profits. No such credit was given to Gama Ltd.

Compute the Arm's Length Price alongwith income to be adjusted under the cost plus method.

Ans. Computation of Arm's Length Price as per Cost Plus Method (Faida mila to hata do )

Particulars	%	%
Gross Profit mark-up on cost in case of Gama Ltd. Ltd. [an unrelated party]		40%
Less: Adjustments for functional and other differences		

- Value of technology support [Alfa Ltd. provides technology support, but Gama Ltd. does not provide such support. Therefore, value of technology support shall be adjusted] [15% of 40%, being gross profit]	6%	
- Quantity discount to Alfa Ltd. [Quantity discount is allowed to Alfa Ltd. as it gives business in large volumes, but the same is not provided to Gama Ltd. Therefore, it shall be adjusted] [10% of 40%, being gross profit]	4%	
- Risk and cost associated with marketing [Beta Ltd. has to bear all the risk and costs associated with the marketing function in case of Gama Ltd., while there is no such risk in case of services to Alfa Ltd. Therefore, market risk and cost shall be adjusted] [20% of 40%, being gross profit]	8%	<u>18%</u>
		22%
<b>Add:</b> Cost of credit to Alfa Ltd. [Beta Ltd has provided credit of 1 month to Alfa Ltd. but not to the unrelated party. Therefore, adjustment for the cost of such credit has to be carried out to arrive at the ALP] [(5% of 40%, being gross profit)]		<u>2%</u>
<b>Arm's length gross profit mark up to cost</b>		<u>24%</u>
Cost incurred by Beta Ltd. for executing Alfa Ltd.'s work		3,50,000
<b>Add:</b> Adjusted gross profit (3,50,000 x 24%)		<u>84,000</u>
<b>Arm's length billed value</b>		<b>4,34,000</b>
<b>Less:</b> Actual Billed Income from Alfa Ltd. (2,500 x 150 man hours)		<u>3,75,000</u>
<b>Total Income of Beta Ltd to be increased by</b>		<u><b>59,000</b></u>

➤ Dec21:

Q. Alpha Inc. having its business in Singapore has advanced a loan of SD 1,50,000 to Alpha Ltd., Bhubaneswar. Book value of total assets of Alpha Ltd. was 120 lakhs. Alpha Ltd. provides software backup support to Alpha Inc. Alpha Ltd., has spent 30,000 man hours during the financial year 2020-21 for the services rendered to Alpha Inc. The cost to Alpha Ltd., is SD 80 / man-hour. Alpha Ltd. has billed Alpha Inc. at SD 85 / man-hour.

Gama Ltd. in Bhubaneswar which has a similar business model, provides software back up support to Beta Inc. in Penang, Malaysia.

Gama Ltd.'s cost and operating profits are as hereunder:

Particulars	Amount (in lakhs)
Direct costs	500
Indirect costs	100
Operating profits	100

(a) Calculate Arm's Length Price for the transaction between Alpha Ltd. and Alpha Inc. based on the above data of Gama Ltd. using the Transactional Net Margin Method. Assume 1 SD = ` 55.

(b) Is any adjustment required be made to the total income of Alpha Ltd.?

Note: SD = Singapore Dollars

Ans. Alpha Ltd. to Alpha Inc. is an international transaction between associated enterprises, the provisions of transfer pricing would be attracted in this case.

Determination of Operating Margin of transaction of provision of software backup support by Alpha Ltd. to Alpha Inc:

Particulars	₹
Billing per manhour [SD 85/hour x 55]	4675
Cost per man hour [SD 80/hour x 55]	4400
<b>Operating profit per manhour</b>	<b>275</b>
Operating profits to cost (%) $[275 \times 100/4400] = 6.25\%$	

Determination of Operating Margin of Comparable Uncontrolled transaction i.e., provision of software backup support. by Gama Ltd. to Beta Inc.

Particulars	in lakhs
Direct Cost	500
Indirect Cost	100
<b>Total cost</b>	<b>600</b>
Operating profits	100
Operating profits to cost (%) $[100 \times 100/600] = 16.67\%$	

1. Computation of Arm's Length Price of provision of software backup support provided by Alpha Ltd. to Alpha Inc. by applying TNMM

Particulars	₹
Cost for Alpha Ltd. (per man hour) [SD 80 x 55/MD]	4,400.00
Add: Arm's length operating profit margin as % of cost (16.67% of 4,400)	733.48
Arm's length price (per manhour) in	<b>5,133.48</b>
Arm's length price of total manhours spent by Alpha Ltd. for providing softwarebackup support to Alpha Inc. $[5,133.48 \times 30,000 \text{ man hours}] =$	<b>15,40,04,400</b>

(2) Adjustment to be made to the total income of Alpha Ltd.

Particulars	₹
Arm's length price of total manhours spent by Alpha Ltd. for providing software backup support to Alpha Inc.	15,40,04,400
Less: Amount actually billed $[85 \text{ SD} \times 55/\text{SD} \times 30,000 \text{ manhours}]$	14,02,50,000
Arm's length adjustment to be made to the total income of Alpha Ltd.	<b>1,37,54,400</b>

➤ **Jan21:**

Same Q as May22

➤ **Nov20:**

KVS Ltd., the assessee, has sold goods on 12.01.2020 to L Ltd., located in notified jurisdictional area (NJA), for ₹ 10.50 crores. During the current financial year KVS Ltd. charged ₹ 11.50 crores from AJ of New York and ₹ 12 crores from KP of London for sale of identical goods and both of which are neither associated enterprise of KVS Ltd. nor they are situated in any NJA. While sales to AJ and KP were on CIF basis, the sale to L Ltd., was on FOB basis, which paid ocean freight and insurance amounting to ₹ 20 lakhs on purchases from KVS Ltd.

India has a Double Taxation Avoidance Agreement with the U.S.A. and U.K.

The assessee has a policy of providing after sales support service to the tune of ₹ 14 lakhs to all customers except L Ltd. which procured the same locally at a cost of ₹ 18 lakhs.

Compute the ALP for the sales made to L Ltd., and the amount of consequent increase, if any, in the profit of the assessee company.

Ans. A transaction where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction and all parties to the transaction would be deemed as associated enterprise. Accordingly, all the provisions of transfer pricing would be attracted in case of such a transaction. Hence, transaction between KVS Ltd. an Indian Company and L Ltd., located in NJA would be deemed to be an international transaction between associated enterprise.

The transactions of KVS Ltd. with AJ of New York and KP of London for sale of identical goods are comparable uncontrolled transaction, since they are neither associated enterprise of KVS Ltd. nor are they situated in NJA. Hence, Comparable Uncontrolled Price method can be used to determine ALP.

Particulars	AJ in crs.	KP in crs.
Price charged by KVS (on CIF basis)	11.50	12.00
Less: Ocean freight and Insurance has to be reduced since the price Charged to L Ltd. is on FOB Basis	0.20	0.20
	11.30	11.80
Less: Cost of after sales support service (to be reduced since such Services are provided to AJ and KJ but not L Ltd.)	0.14	0.14
Arm's Length Price	11.16	11.66
Arithmetic Mean of above prices	11.41	
Less: Price at which goods sold to L Ltd.	10.50	
Arm's length adjustment (increase in profit)	0.91	

