TRANSACTIONAL NET MARGIN METHOD- BRIDGING THEORY AND PRACTICE IN TRANSFER PRICING

Introduction

The ever-expanding dynamics of global trade and cross-border investments, transfer pricing mechanism for transactional validity has become increasingly apparent. Multinational enterprises are challenged through and through while operating in multiple tax jurisdictions. Transfer pricing is of profound use to them in allocation of profits ensuring beneficial tax structure in each jurisdiction, additionally preventing both tax evasion and double taxation.

Transfer pricing

MNEs work on the guiding principle of allocating profits to jurisdictions with favorable tax regimes and minimizing tax burdens. The companies' profitability has significant implications on the tax revenues of the countries in which these entities operate. By shifting the profits, transfer pricing offers a balanced approach to appreciate the interests of either side by applying the arm's length principle while evaluating a transaction. The arm's length pricing standardizes evaluating transactions of related entities with that of unrelated entities. Nonetheless, applying transfer pricing principles requires continuous vigilance, specifically a check on the variants of the arm's length principle, to prevent its abuse in profit-shifting schematics that threatens the economics of the tax avenue.

Organization for Economic Co-operation and Development (OECD) developed a series of guidelines and frameworks around transfer pricing and enforce arm's length principle to address the nuances of transfer pricing by introducing Article 9 of OECD/UN transfer pricing model. This principle dictates that transactions of related parties should be adjudged on the same sphere as if they were between unrelated parties, ensuring that profits are appropriately taxed where they are generated. MNEs escape through loose ends of arm's length principle typically by channeling transfer prices in specific way such that high expenditure and reduced profits are shown in subsidiary established in high-tax country, while inflated profits are shown in low-tax country or tax haven.

Arm's length principle

The principle laid down in Article 9 of OECD Model Tax Convention as follows: "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

There are enlisted methods to determine arm's length principle as accepted by countries at OECD would be:

1. Comparable Uncontrolled Price (CUP) Method: Evaluates transaction prices between related parties by comparing them with similar transactions between unrelated entities. When dealing with identical or similar products, this approach proves highly effective as it enables direct price comparison with market rates. The method accounts for variations in contractual terms and product characteristics through appropriate adjustments.

2. Resale Price Method (RPM): determines arm’s length price by working backward from the final selling price to an unaffiliated customer. this process involves deducting a market-appropriate gross profit margin that considers the reseller's activities and market conditions. after accounting for operational expenses, the remaining value represents the arm’s length price. This method is best suited for purchase and resale transaction with minimum value addition.

3. Cost Plus Method (CPM): Determines arm’s length price by adding an appropriate profit margin to the production or service costs in related-party transactions. The markup should match profits earned in comparable independent transactions. This method proves valuable for scenarios involving transfers of work-in-progress goods or services between affiliated entities.

4. Profit Split Method (PSM): Allocates combined profits from related-party transactions based on each entity's contribution. This approach excels in complex situations where multiple parties provide unique assets or capabilities. The profit distribution reflects each participant's functional roles, asset utilization, and risk exposure.

5. Transactional Net Margin Method (TNMM): Examines net profit margins from controlled transactions against those from similar uncontrolled transactions. The analysis uses relevant financial metrics like costs, revenue, or assets as comparison bases. This method proves useful when gross profit data lacks reliability but net profit information remains available.

6. Other Methods: Offers flexibility to employ alternative approaches when standard methods prove inadequate. This method relies on independent market data to establish arm's length conditions, particularly useful for examining unconventional or complex transactions.

An appropriate method to calculate arm’s length price in transfer pricing depends upon the specificity of each transaction, available data and the business the enterprise is involved in. Each method has unique strengths and limitations that make it suitable. CUP method offers exact price comparisons between controlled and independent transactions but is limited by the availability of finding right data to compare as it is difficult when the products has unique character. RPM works well for distribution chains with minimal product alterations, examining gross margins from third-party sales, though market conditions must match closely. CPM suits manufacturing and service transactions by adding appropriate markups to production costs yet requires thorough cost analysis and market comparable. The suitability diminishes when significant value is added to goods post-

purchase or when the reseller's activities differ substantially from those of the original supplier. PSM handles complex business structures where multiple parties contribute distinct value, distributing profits based on individual contributions, though profit allocation often involves subjective judgments. Determination of each party's share becomes a drawback as the allocation is based on estimation and assumptions rather than crystallized rubrics. Consequently, PSM can be contentious if allocation methods lack objective benchmarks. TNMM proves useful when net profit data exceeds gross profit availability, measuring profitability against bases like sales or assets, but might oversimplify intricate business relationships. Lastly, the Other Method offers a flexible approach, permitting companies to rely on alternate reasonable methodologies when none of the standard methods apply adequately. While this flexibility can be beneficial, it may lead to disputes, as the lack of a structured framework can make it harder to establish a defensible position. The Other Method is usually best for transactions that are atypical or difficult to assess with conventional models, although its use must be carefully documented to avoid challenges from tax authorities. In practice, selecting the optimal transfer pricing method involves a thorough evaluation of each transaction's nuances, data accessibility, and the complexity of intercompany arrangements. Often, a single method may not fully capture all relevant economic aspects, making it necessary to apply multiple methods in tandem to support a more accurate and defensible transfer pricing position.

Case of Kellogg India

Kellogg India, a wholly-owned subsidiary of Kellogg's, an American company, was under scrutiny of income tax for the payments made to its parent company. The authorities alleged that Kellogg India had made undisclosed profits by showing inflated payments under the guise of royalty and services to its parents company in USA, as an affect it reflected less profits in the books than the actual. The Court adjudged the case on transactional net margin method upholding the righteous nature of payments made by the Kellogg India to its parent company, in line with arm's length principle. The ruling was in favour of Kellogg India on the observations that the transactions made were similar to that if it had been made to unrelated parties and dismissed the claims of tax authorities.

The court's decision affirmed that Kellogg's pricing mechanism adhered to benchmarking standards, which are critical in transfer pricing as they set the reference for acceptable transaction values between related parties. Benchmarking involves comparing the terms, prices, and profit margins of a controlled transaction (such as between Kellogg India and its parent company) with those of similar transactions between unrelated parties. By doing so, it establishes that the pricing aligns with the arm's length principle, ensuring fairness and consistency. The court found that Kellogg's internal pricing complied with this standard, signifying that their intercompany transactions did not deviate from what would typically occur in the open market. In addition, the judgment supported market parity in transfer pricing practices, meaning that Kellogg's transactions mirrored those of independent entities under similar market conditions. Market parity seeks to

prevent any undue advantage that might arise from profit shifting by ensuring that prices set between related parties match those that would prevail in competitive, unrelated transactions. In this case, the court determined that Kellogg's transactions did not confer any excessive benefit or tax advantage, reinforcing the notion that the company's pricing did not distort competitive balance or result in tax avoidance. This upholding of market parity safeguards economic fairness, as it ensures that tax revenue bases remain unaffected by manipulative practices in intercompany transactions.

In effect, the judgment reasserted the importance of adhering to arm's length pricing to protect both the tax base and competitive standards within the market, thereby preserving the integrity of transfer pricing frameworks.

The ratio of Kellogg India case recites the presence of complexities in transfer pricing frameworks, particularly transactional net margin method when applied to internal transactions of the company. The court iterated that related-party transactions could still align with arm's length principle when appropriately benchmarked and follows set standards for independent or unrelated-party transactions. However, the reasoning is critically opposed when the benchmarking is beyond one certain jurisdiction or where contesting the method is across various tax jurisdictions MNEs are established. The court recognized that the method is equipped in theory to provide flexibility and simplicity in price evaluation and comparison of net margins rather than optimizing equivalent transactional value. Yet, in practice, flexibility is used to the advantage of MNEs to engage in profit sharing practices. By benchmarking their Indian subsidiary's net margins to the lowest acceptable levels, MNEs often demonstrate minimized profits in higher-tax jurisdictions like India while channeling substantial profits to tax haven jurisdictions where the tax obligations are minimal or nonexistent. The manipulation is a kick on tax revenue of India by facilitating tax base erosion as well as disrupts market structures. The mechanism of showing underreported profits in high-tax jurisdiction by MNEs creates artificial costs that are leveraged to set lower prices in the market. This practice reduces competition as smaller or local competitors, who report genuine profitability, find it difficult to match these artificially deflated prices. Consequently, negative benchmarking ensues, where other firms within the same sector feel pressured to reduce prices or report similar margins to remain competitive, despite potentially incurring losses. Such practices, left unchecked, have broad implications for market stability and industry health, as they erode genuine competitiveness and diminish the transparency of financial performance across the sector.

On this objective, the Kellogg India case emphasizes the urgency of more stringent transfer pricing laws, with intricate detailing to eliminate possible exploitation through reading between the laws. Although the court recognized transactional net margin method to determine related-party transactions on set rules of independent party transactions, it also highlighted its susceptibility to abuse, necessitating a robust regulatory approach. In the absence of strict regulations, the continuous manipulation of TNMM will erode tax bases and destabilize market standards, thereby threatening economic equity and fair competition.

Transactional net margin method practiced in India

The versatility of the method allows MNEs to manipulate revenue by using technical data that skews the profitability metrics or by opting for benchmarking entities that might not be in the similar in comparison to Indian subsidiary. Due to this legal loophole, multinational enterprises are allowed to move profits to tax havens and reduce taxable income in India, which causes the Indian government to lose a substantial amount of tax money. Another popular strategy is intellectual property (IP) structuring, in which MNEs charge their Indian subsidiaries outrageous royalties or service fees for using a company's patents, trademarks, or other IP assets in a tax haven. This strategy significantly weakens India's tax base by causing significant capital outflows from India to the low-tax nation. Such evasion tactics furbish economic repercussions of base erosion by shifting profits from high-tax jurisdictions to low-tax jurisdictions eventually burdening the treasury of India with heavy loss of tax revenue.

Changes for improved transfer pricing mechanisms

Consider a hypothetical case, a U.S.-based MNE's Indian subsidiary uses TNMM to claim a net profit margin of 2%, whereas the parent company's global profit margin is 10%. The arrangement is such that the Indian subsidiary reduced its taxable income in India by paying its parent business large sums for the usage of intellectual property. In this instance, profits were transferred outside of India by manipulation of the TNMM mechanism. By implementing a robust anti-avoidance framework beyond double taxation agreements, such as advance pricing agreements between authorities and taxpayer however with a set standard rather than discretionary based on tax jurisdiction which confirms with other States as well. The Indian tax authorities could enforce more stringent rules on intra-group payments, especially those pertaining to intellectual property, and make sure that they are economically justified. In order to ensure that earnings are taxed where the real economic activity occurs and to provide a clearer picture of global profit allocation, country-by-country reporting and master file that demand the disclosure of functional analysis (functions, assets, and risk profiles). This strategy will eliminate profit-shifting, in which multinational corporations (MNEs) use low-margin companies as benchmarks to selectively justify lower profitability in their Indian operations, by improving comparability criteria. MNEs would have less room to fraudulently inflate reported earnings in India if there were a more stringent comparability framework in place. This would guarantee a more equitable assessment that more accurately represents the economic realities of the Indian market. In addition to providing a more trustworthy foundation for determining arm's length prices, this will help level the playing field for competition and discourage multinational enterprises from using profit-shifting strategies that lower taxable revenue under Indian law.

Furthermore, enforcing stricter disclosure laws and increased openness will support initiatives to stop tax evasion through deceptive transfer pricing schemes. MNEs would have to provide thorough information on their worldwide profit distribution, tax payments, and the particulars of their cross-

jurisdictional economic operations under a more stringent disclosure framework. A clearer, more comprehensive picture of how and where MNEs are creating value and distributing profits would be made available to Indian tax authorities through this openness, allowing for greater examination of transfer pricing agreements. By disclosing any profit-shifting tactics that hurt India's tax base, these disclosures may highlight discrepancies between the value generated in India and the profits declared. Equipped with this knowledge, tax officials would be in a better position to contest dubious transfer pricing schemes, encouraging a more equitable allocation of tax income in accordance with real economic activity. Because MNEs would be less inclined to use aggressive tax planning techniques due to the increased risk of regulatory scrutiny and public responsibility, this degree of transparency might also serve as a deterrent.

Conclusion

International taxation ahs made lot of progress on the subject of transfer pricing, yet there so much to do. In conclusion, while significant strides have been made in addressing transfer pricing challenges, much remains to be accomplished to secure fair taxation in a globalized economy. The arm’s length principle remains a cornerstone of transfer pricing regulation, offering a balanced framework for evaluating related-party transactions. However, it is clear that increased specificity, comprehensive comparability standards, and stricter disclosure requirements are essential to mitigating abuse and safeguarding the fiscal health of high-tax jurisdictions like India. Enhanced regulations, including country-by-country reporting, robust anti-avoidance frameworks, and transparent benchmarking, can ensure that multinational enterprises pay taxes where genuine economic activity occurs. By closing current regulatory loopholes, these measures would not only protect national tax bases but also promote fairness and transparency in international business practices, ensuring that transfer pricing mechanisms contribute to equitable growth and stability in the global economy.