10 issues in benchmarking Commodity Exchange Price-quotes as CUP

Date : 5 May 2015

Nilesh Patel (Managing Partner, Taxwize)

Sagar Gandhi (Partner, Taxwize)

1. Background

Commodity transactions, both exports and imports, are quite common between Associated Enterprises (AEs). These transactions have one distinct feature: the prices are quoted in public on reputed Commodity Exchanges (e.g. London Metal Exchange, Chicago Board of Trade, Multi Commodity Exchange of India, Malaysian Palm Oil Board,etc.) and published by reputed Price Reporting Agencies (PRAs - like World Oil, Argus, Platts, Bloomberg,etc). Data of independent third party transactions, therefore, is available in plenty in the form of price-quotes, on exchanges and in reports of PRAs.

2. Use of Price-Quotes as CUP

Can we use those price-quotes to apply the CUP (Comparable Uncontrolled Price) method for determining the Arm's Length Price (ALP) of commodity transactions between AEs? The answer is relevant because the ITAT has ruled that though there is no hierarchy or priority of methods prescribed under the Indian Transfer Pricing Regulations, CUP is yet the best method as it is the most direct method[1].

The ITAT has upheld - in several cases –the use of price-quotes for applying the CUP method[2]. The most recent such case is *Cargill Foods India Limited (TS-151-ITAT-2015(PUN)-TP).*

Also, the **OECD** has proposed - in its Discussion Draft on BEPS Action 10[3] - the use of CUP as the most appropriate method, to benchmark commodity transactions between AEs, with reference to price-quotes available on commodity exchanges.

To be sure, couple of contrary decisions, however, have also been rendered by the ITAT: (i)*Sinosteel India P. Ltd (TS-341-ITAT-2013(DEL)-TP)*; and (ii) *Noble Resources & Trading India P. Ltd (TS-73-ITAT-2014(DEL)-TP)*. There the ITAT ruled that Quotation which has not fructified into a Transaction cannot be accepted as CUP.

3. Comparability Adjustments when CUP Method is used

The naked price-quotes on commodity exchanges cannot be directly adopted as CUP, but can be a good reference point to arrive at CUP, after making necessary comparability adjustments. For example, there could be differences in terms and conditions, volume or quantity, delivery terms (CIF or FOB), credit or payment terms, of the controlled transaction and uncontrolled transactions (whose quotes are reflected on the exchanges). So, it would generally not be appropriate to straight away adopt price-quote as CUP, without making appropriate adjustments.

The ITAT has appreciated the need for following comparability adjustments under CUP method:

- Adjustment for the cost of funds invested and the related credit risk, in giving excess credit period, in the uncontrolled transaction[4]
- Adjustment for Volume Discount given to AE, for high volume of sales to AE, as compared to volume of

sales to third parties[5]
- Adjustments for differences in contractual terms of controlled transactions and uncontrolled transactions[6]
- Adjustments for insurance and freight[7]

4. The Other Method

In *Toll Global Forwarding India Pvt Ltd* (*TS-383-ITAT-2014(DEL)-TP*) the ITAT adopted realistic & purposive interpretation to 'Price' under CUP. The ITAT held –

- The Other Method prescribed in Rule 10AB is not a residual method.
- So, it is not necessary that first the five specified methods must fail and only then this method be applied.
- This method is at par with all other methods of determining the ALP.
- The Other Method is a direct method like CUP, RPM and CPM. So, it has an inherent edge over indirect methods such as TNMM and PSM.
- The Other Method may permit use of bonafide quotations.

Further, in *Global One India Private Limited [TS-115-ITAT-2014(Del)* it was ruled that if the PSM, as applied by the Taxpayer, did not fall within the strict definition of PSM provided in Rule 10B(1)(d), then the same could be considered as "The Other Method" (Sixth Method).

5. It is not mandatory to apply TNMM

The discussion made above supports the proposition that we may use prices, quoted on exchanges, under either CUP or the Other Method. So it is not mandatory to consider TNMM, to benchmark controlled commodity transactions.

6. Controlled Transaction Price (CTP) and Uncontrolled Transaction Price (UTP – unadjusted CUP)

To benchmark commodity transactions under CUP, or the Other Method, we have to compare the CTP with the price-quotes available, on exchanges or in reports of PRAs, and then make appropriate comparability adjustments.

A question arises here: Should UTP be the price-quote as on the date of execution of the Contract or on date of Invoice or on date of shipping? Ordinarily, UTP is the price-quote (on exchange) on the Invoice Date.

6.1 Pricing Date

But what if the Invoice Date is manipulated, subsequent to the controlled commodity transaction, to favourably match the CTP with UTP (price-quotes on exchanges)? Considering this possibility the **OECD** has proposed in its Discussion Draft on BEPS Action 10[8] that, in the absence of reliable evidence of the pricing date actually agreed by the AEs, the pricing date shall be deemed to be the shipment date, as evidenced by the bill of lading. Therefore, in tax-avoidance cases the UTP will be the price-quote on the Shipping Date, not on the Invoice Date. The OECD, however, is yet to finalize its recommendations.

For our purposes we may, however, adopt the 'Invoice Price' as CTP and the 'Exchange Price-Quotes on Invoice Date' as UTP. But if there is evidence of abuse, the Tax Authorities may consider the 'Exchange Price-Quotes on Shipping Date'as UTP (unadjusted CUP).

7. Mechanism of applying CUP: Comparison of Invoice-by-Invoice Prices or Comparison of Average Prices?

In the context of commodity transactions the ITAT[9] has held that we cannot benchmark the CTP (price of transaction between AEs) of commodity transactions on average basis (viz. average of CTP); rather, we should benchmark such CTP on invoice-by-invoice basis. The UTP (price of uncontrolled transaction between third parties), however, may be taken as the average of price-quotes.

In practice, to smoothen out price fluctuations and minor variations in quality, we may take the average of price-quotes over a time, say, either on daily, weekly, monthly or quarterly basis, because commodity markets are volatile[10]. This accords with the industry practice. The time period – daily, weekly, monthly or quarterly – over which average is to be drawn would depend on the industry practice for the particular commodity traded between AEs, and on the number of price-quotes available on exchanges. If there are sufficient number of daily price-quotes, then daily average may be fine. Otherwise, we may have to consider longer time periods to compute the average.

[**Note**: Once the concept of Range is activated under the Third Proviso to Sec. 92C (2), we might be able to apply inter-quartile range to pick up the UTP price point.]

8. Sample Testing versus Testing of each and every Transaction

If the volume and frequency of controlled commodity transactions between AEs is high, (say, number of transactions happen daily or weekly), then we may resort to sample testing[11]. That is, we may take few sample invoices per day,or per week, and test their prices against the price-quotes. Thus, we may not test all the invoices but only a statistical sample of invoices. Testing all transactions would be overly burdensome and contrary to the OECD Guidelines[12].

9. Sec 92(3) and Set offs

Consider the following figures of commodity exports to AE made by an Indian Taxpayer –

Sr.no	Invoice-Date	Invoice-Price (Exports)	Average (Monthly) Price-Quote During Invoice-Month	Difference
1	10 April 2015	100	105	5
2	25 April 2015	110	105	(5)
			Total	0 (Nil)

Issue: Should TP adjustment be 5 or Nil? Drawing support from Delhi High Court's Verdict in *Sony Ericsson Mobile Communications India Pvt Ltd,ITA No. 16/2014, Dated 16-03-2015* we may argue that the excess sale price realised in one transaction may be set-off against the deficient price in another transaction, so long as the TP adjustment is not negative as a whole (so as to reduce the income as per books). So, in the example depicted above there would be no TP adjustment.

10. How to Test the Tolerance Band of +-1% and +- 3%?

In case of *The Development Bank of Singapore [TS-112-ITAT-2013(Mum)-TP]* the ITAT held that under the amended Proviso to Sec. 92C (2) the benefit of tolerance band is available even where a single price is determined as ALP. There is, however, an adverse decision in *UE Trade Corporation India (P) Ltd (TS-28-ITAT-2010(DEL))*.

But we may rely on the favourable decision in the former case and test the Tolerance Band on transaction-by-transaction basis, for each Invoice separately.

11. Conclusion

We may use prices, quoted on Commodity Exchanges or in reports of Price Reporting Agencies, to apply CUP for benchmarking commodity transactions between AEs. But we will have to make appropriate comparability adjustments. And when there is some doubt about comparability of price-quotes, we may invoke the Other Method. So, we need not generally apply TNMM to benchmark commodity transactions.

While making comparability analysis, we may consider the average of price-quotes. The time-period for such average will depend on circumstances of the Taxpayer, volume of price-quotes available, volatility in the market and the industry practice. The average of price-quotes should be compared with the actual controlled transaction price on invoice-by-invoice basis. But excess price in one transaction may be set-off against deficient price in another transaction. Also, the +-1% or 3% tolerance range may be tested invoice-by-invoice. And where the volume and frequency of controlled transactions is high we may resort to statistical sample testing under CUP method.

Under its BEPS Action 10 the OECD has already issued a Discussion Draft on Transfer Pricing aspects of Cross-border Commodity Transactions. Let us wait and see what the OECD finally recommends.

---

[1] (i) Serdia Pharmaceuticals (India) Private Limited vs ACIT [2011] 9 taxmann.com 13/44 SOT 391 (ITAT Mumbai); (ii) Clear Plus India (P) Ltd vs CIT [2011] 10 taxmann.com 249 (ITAT Delhi); (iii) ACIT vs MSS India Pvt Ltd [2009] 32 SOT 132 (ITAT Pune)

[2](i) KTC Ferro Alloys Pvt Ltd (TS 20 ITAT 2014 (Viz) TP);(ii) Adani Wilmar Limited (TS-114-HC-2014(GUJ)-TP); (iii)A. M. Todd Co. India P. Ltd (TS 117 ITAT 2009 (Mum);(iv) Vipin Enterprises (TS-32-ITAT-2012(DEL) – upheld by High Court and Assessee's SLP dismissed by SC;(v) MSS India P. Ltd (TS-14-ITAT-2009(PUN)-TP)

[3] Public Discussion Draft, OECD BEPS Action 10 (16 Dec 2014 – 6 Feb 2015): Transfer Pricing aspects of Cross-border Commodity Transactions

[4] (i) Vipin Enterprises (TS-32-ITAT-2012(DEL); (ii) Cox & King (India) (P) Ltd vs ITO [2010] 42 SOT 15 (ITAT Mumbai) (URO); (iii) Henkel Adhesives Technologies India (P.) Ltd vs DCIT [2014] 45 taxmann.com 197/[2014] 64 SOT 111 (ITAT Pune)(URO)

[5] (i) Diamond Dye Chem Ltd vs DCIT (2010-TII-20-ITAT-MUM-TP); (ii) CIT vs Dufon Laboratories [2010] 39 SOT 59 (ITAT Mumbai)

[6] (i) Drilbits International (P) Ltd vs DCIT [2011] 142 TTJ 86 (ITAT Pune); (ii) Alfa Laval (I) Ltd vs ACIT [2014] 46 taxmann.com 394/[2014] 149 ITD 285 (ITAT Pune)] ; (iii) ACIT vs Truetzschler India (P.) Ltd [2014] 44 taxmann.com 142 (ITAT Mumbai)

[7]MSS India P. Ltd (TS-14-ITAT-2009(PUN)-TP)

[8]Public Discussion Draft,OECD BEPS Action 10 (16 Dec 2014 – 6 Feb 2015): Transfer Pricing aspects of Cross-border Commodity Transactions

[9](i) Tilda Riceland Pvt Ltd (TS-47-ITAT-2014(DEL)-TP); (ii) UE Trade Corporation India (P) Ltd (TS-28-ITAT-2010(DEL))

[10] Tilda Riceland Pvt Ltd (TS-47-ITAT-2014(DEL)-TP)

[11] Rev. Proc. 2011-42 issued by the US Internal Revenue Service

[12] Paragraph 5.6 of the OECD Guidelines (July 2010): "…tax administration should take great care to balance its need for the documents against the cost and administrative burden to the taxpayer of creating or obtaining them".