United Spirits Limited

Report on related party transactions
with Diageo Brands B. V. Netherlands

18 May 2023

Building a better working world

Contents

Glossary

Abbreviations	Full Name
Act	Companies Act, 2013
AC	Audit Committee
ALP	Arm's Length Price
BII	Bottled in India
BIO	Bottled in Origin
BSE	Bombay Stock Exchange
CPM	Cost Plus Method
CUP	Comparable Uncontrolled Price
DBBV	Diageo Brands BV, Netherlands
Diageo Group	Diageo Group and its subsidiaries
DSL	Diageo Scotland Limited
EY	Ernst & Young LLP, India
FY	Financial Year from 01 April to 31 March
IMC	In-Market Company
IMFL	Indian Made Foreign Liquor
INR	Indian Rupees
NSE	National Stock Exchange
OECD TP Guidelines	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022, issued by Organisation for Economic Co-operation and Development
PSM	Profit Split Method
RPM	Resale Price Method
RPT	Related Party Transactions
SEBI LODR	Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 [Last amended on 07 February 2023]
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
USL	United Spirits Limited
UN	United Nations

1 Executive summary

1.1 Background

- USL is a public company domiciled and headquartered in Bengaluru, Karnataka, India. It is incorporated under the Companies Act, 1956 and its shares are listed on the BSE Limited and NSE Limited. The Company is engaged in the business of manufacture, purchase (net of re-exports) and sale of beverage alcohol and other allied spirits, including through tie-up manufacturing units and strategic franchising of some of its brands[1].

- Section 188 of the Companies Act, 2013 ("the Act") provides that transactions with related parties which are undertaken on an arm's length basis and in the ordinary course of business, are exempted from the obligation of obtaining prior approval of shareholders. However, with effect from 01 April 2022, Regulation 23 of the SEBI LODR mandates prior approval of shareholders through ordinary resolution for all 'material' related party transactions ("RPTs"). For this purpose, a transaction with a related party shall be 'material' if, such transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds INR 1,000 Crores or 10% of annual consolidated turnover of the Company as per the latest audited financial statements, whichever is lower.

- USL undertakes transactions with various Diageo Plc Group entities which are considered as "related parties" for the purpose of the Act.

- USL shall undertake the following transactions with DBBV for the FY 2023-24:

    - Purchases (net of re-exports) of BIO brands for distribution in India market;

    - Purchase (net of re-exports) of bulk scotch for manufacturing Diageo brands in India (BII segment);

    - Purchase (net of re-exports) of bulk scotch for manufacturing USL brands (IMFL);

    - Availing/ rendering any kind of service, or any other transaction(s) for transfer of resources, services or obligations and other reimbursements/ recoveries.

- It is anticipated that the transactions with DBBV are expected to cross the threshold of INR 1000 crores for the financial year 2023-34 and therefore would require the prior approval of the shareholders.

- EY has been engaged by USL to review the arm's length nature and ordinary course of business of the RPTs that shall be undertaken by USL for FY 2023-24 with DBBV, from the standpoint of the Act and the SEBI LODR.

- The analysis has been undertaken based on facts provided and confirmed by USL.

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[1] Source: USL Annual Report 2021-22, Page 125

1.2 Report Overview

In addition to the executive summary section of the report, the remainder of the report is organized as follows:

- Section 2 provides the nature of the RPTs and their relevance from business perspective.
- Section 3 provides comparability analysis of the RPTs;

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1.3 Executive summary

- Due to the change in consumption pattern, there has been an increase of the demand for Diageo and USL brands in the Indian market. Post acquiring the controlling stake in USL by Diageo, USL has been purchasing the Diageo-owned BIO brands for distribution in India and bulk scotch for manufacture of Diageo brands and USL's own brands. These transactions have been historically undertaken by USL with Diageo group affiliate entities since 2015 and shareholder approval is being sought for FY 2023-24, as the value is expected to exceed INR 1000 Crore.

- The RPTs proposed to be undertaken by USL with DBBV can be considered to be in ordinary course of business and at arm's length, protecting the interest of minority shareholders and exhibiting economic benefit for all the interested related parties. Further, as highlighted above, the pricing, financial arrangements and other commercial terms of the RPTs are comparable to those which an independent enterprise would enter into.

- Provided below are the comparable results:

Nature of RPT	Method selected	Comparables		Remarks
		Type of comparable data	Arm's length range	
Purchase (net of re-exports) of BIO brands for distribution in India market	TNMM using OP/OR as PLI	Companies engaged in similar activities	35th Percentile – 3.19% Median – 4.20% 65th Percentile – 7.85%	The operating margin earned by USL is higher than the 65th percentile
Purchase (net of re-exports) of bulk scotch for manufacturing Diageo brands in India (BII segment)	TNMM using OP/OR as PLI	Companies engaged in similar activities	35th Percentile – 6.00% Median – 7.50% 65th percentile – 9.18%	The operating margin earned by USL is higher than the 65th percentile
Purchase (net of re-exports) of bulk scotch for manufacturing USL brands (IMFL)	TNMM using OP/OR as PLI	Companies engaged in similar activities	35th Percentile – 6.00% Median – 7.50% 65th percentile – 9.18%	The operating margin earned by USL is at arm's length

Nature of RPT	Method selected	Comparables		Remarks
		Type of comparable data	Arm’s length range	
Availing/ rendering any kind of service, or any other transaction(s) for transfer of resources, services or obligations and other reimbursements.	TNMM using OP/OC as PLI	Companies engaged in similar activities	35th Percentile – 4.20% Median – 7.73% 65th percentile – 12.97%	The mark-up charged is at arm’s length

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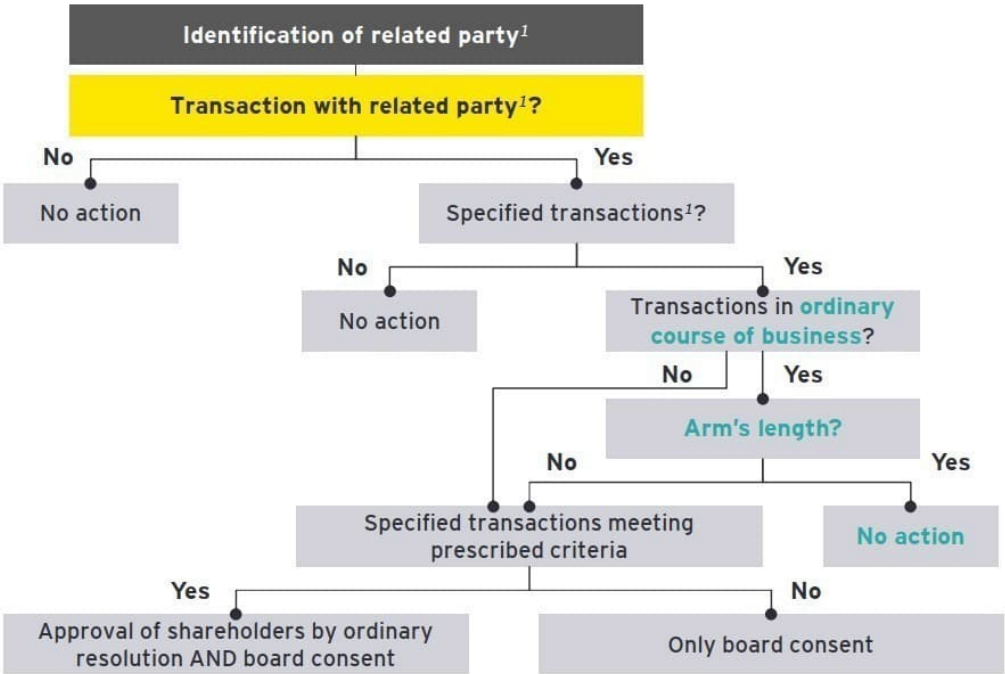
2 Introduction

2.1 Requirement under the Act and SEBI LODR

► Requirement under the Act:



[1] *As per amendment made to SEBI LODR and as approved in February 2023*

► Additional requirement under SEBI LODR:

Wider related party definition: As per the SEBI LODR, the related party definition as per the Act has been widened to include any person or entity belonging to the promoter or promoter group of the listed entity, or any person holding 10% or more equity share capital in the listed entity, or on beneficial interest basis as provided under the Act.

Approvals: As per the SEBI LODR, prior approval of shareholders shall be required for material RPTs having a threshold of INR 1,000 Crores or 10% of the consolidated annual turnover of the listed entity, whichever is lower. Further, prior approval of the Audit Committee ("AC") will be required for:

a) All RPTs and subsequent material modifications as defined by the audit committee; and

b) With effect from 01 April 2023, RPTs where subsidiary is party but listed entity is not a party, subject to threshold of 10% of annual turnover of the subsidiary's standalone financial statements.

The SEBI LODR requires each listed entity to formulate a policy on materiality of RPTs including clear threshold limits duly approved by the board of directors. Such policy should also be reviewed by the board once every 3 years and updated accordingly.

- ► Concept of ‘ordinary course of business’:

The Act does not lay down any specific guidelines for determining the transactions undertaken to be in the ordinary course of business. Generally, the “object clause” of the MoA is referred to in determining whether the transaction is undertaken in the ordinary course of business; however, this is not a conclusive test always.

If a transaction is happening quite frequently over a period of time, it is more likely to be treated as an ordinary course of business. However, the inverse does not necessarily hold true. Business purpose and size and volume of transaction may also be considered when analysing whether a transaction is in the ordinary course of business. The audit committee may decide based on the RPT policy on the transactions. The RPT policy should specify the parameters to guide the audit committee on whether a transaction is in the ordinary course of business or not. A company may formulate guidelines approved by the audit committee and the board of directors on RPTs. Transactions entered into based on the approved guidelines need not be placed before the audit committee for determining whether the same is in the ordinary course of business or not.

- ► Concept of ‘arm’s length’:

The Act and the rules thereto, do not contain any guidance on how to benchmark or determine the ALP for transactions between related parties.

The OECD TP Guidelines provide a framework for analysing intercompany transfer prices. Specifically, the OECD TP Guidelines specify that the prices set for intercompany transactions should be based on the “arm’s length principle”. Many of the developed countries are members of the OECD and have endorsed or follow the OECD TP Guidelines and the arm’s length principle as being consistent with their local country TP guidelines and regulations.

The Indian transfer pricing regulations are also broadly based on the OECD TP Guidelines. Even though India is not a member of the OECD, the OECD TP Guidelines have been recognized as providing useful aid in applying the Indian TP rules to the extent they are not inconsistent with the Income-tax law.

Under the arm’s length principle, transactions within a group are compared to transactions between unrelated entities under comparable circumstances to determine the range of arm’s length prices/ margins. The rationale for the arm’s length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities. Hence, for the purpose of this analysis, reliance is placed on the principles arising from the OECD TP Guidelines, UN TP Manual and the Indian TP regulations as contained under Income-tax law, as appropriate.

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2.2 Relationship between USL and Diageo Group

Diageo plc is a public limited company in England and Wales, listed on both the London Stock Exchange ("LSE") and the New York Stock Exchange ("NYSE").

Diageo owns many of the world's most recognizable brands, and its operations include the development, production, distillation, brewing, bottling, packaging, distributing, and marketing of those brands. Diageo Group is a global leader in beverage alcohol. The group provides consumers with choice and quality across categories and price points. Diageo group produces various branded products from 132 sites in over 30 countries. It operates in 21 markets around the world and have presence in over 180 countries, employing 27,987 people across their global businesses .

Diageo owns over 200 brands, with sales in more than 180 countries, including a market leading position in international spirits in the United States and fast growing businesses in India and China. Diageo owns two of the world's four largest premium spirits brands (Johnnie Walker and Smirnoff) and 23 of the world's top 100 premium spirit brands.

United Spirits Limited is a public listed company and engaged in the business of manufacture, purchase (net of re-export) and sale of beverage alcohol and other allied spirits, including through tie-up manufacturing units and through strategic franchising of some of its brands. Post-acquisition of controlling stake in USL in July 2013, Diageo Relay BV currently holds 55.94% stake in USL as a result of which Diageo group entities, including DBBV, are considered as related parties of USL as per the Act and SEBI LODR, for the purposes of this report.

2.3 Transactions with Diageo Brands B.V. Netherlands ("DBBV")

USL shall undertake the following transactions with DBBV for the FY 2023-24:

- Purchase (net of re-exports) of BIO brands for distribution in India market;
- Purchase (net of re-exports) of bulk scotch for manufacturing Diageo brands in India (BII segment);
- Purchase (net of re-exports) of bulk scotch for manufacturing USL brands (IMFL);
- Availing/ rendering any kind of service, or any other transaction(s) for transfer of resources, services or obligations and other reimbursements/ recoveries.

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2.4 Determination of arm's length basis and ordinary course of business for transactions with DBBV

2.4.1. Business rationale for undertaking RPT with DBBV

2.4.1.1. Demand for Diageo brands and USL brands and therefore the need to purchase from DBBV

The number of middle-class consumers in India are increasingly purchasing premium and prestige local spirit brands as their income levels rise. This has led to an increased demand of various Diageo and USL brands in India. The demand for alcoholic beverages has increased as a result of a number of factors, including rapid urbanization, shifting consumer preferences, and a sizable and expanding middle-class population with rising purchasing power. The emergence of affordable premium labels and people's changing drinking habits, particularly among the younger generation has changed the landscape of alcohol industry in India. Distribution by the Company in India of such premium brands owned by Diageo has positively contributed to the premiumisation journey of the Company in line with the evolving Indian market's strategic shift towards premium products. In order to cater to the increased demand, the Company imports, manufactures, and distributes some of the iconic Diageo brands, such as Haig Gold Label, Captain Morgan, Johnnie Walker, J&B, Baileys, Lagavulin, Talisker, VAT 69, Black & White, Smirnoff and Ciroc in India under different licensing agreements. Further, USL also manufactures and sells its own brands to meet the growing demand. Some of these products require critical inputs/ materials from Diageo group entities.

USL has been undertaking these RPTs with DBBV, since 2015. Therefore, from the above it can be concluded that the purchases (net of re-exports) from DBBV are regular business transactions undertaken in the ordinary course of business.

2.4.1.2. Other business reasons

In addition to the need for USL to purchase from DBBV in order to cater to the end customer demand, there are numerous other business reasons due to which USL benefits from transactions/ purchases with DBBV. These are enumerated below:

- Diageo Plc is the largest producer of scotch with the highest market share of 38% (in terms of volume) and the nearest competitor being Chivas Brothers with 20%, and other fragmented significantly smaller distilleries (William Grant & Sons, Bacardi, Whyte & Mackay) having market shares ranging between 1%-8%[2]. Being a large scale producer, USL benefits from uninterrupted and regular supply from Diageo.

- Even prior to acquiring controlling stake in USL, Diageo sold its products through its wholly owned subsidiary in India. Considering USL strong market presence in India with its own brands, association with Diageo group only further strengthened USL market position. It created opportunities for USL to deal in products which otherwise it could not have and consolidate its

[2] source: https://www.whiskyinvestdirect.com/about-whisky/top-15-scotch-whisky-companies

market leading position in India.

- The increase in the product portfolio of USL with the addition of Diageo brands has contributed to absorption of fixed costs incurred by the Company by realising synergies including in areas of manufacturing, marketing, distribution, overheads etc. Further, these arrangements results in an improvement in Return on Invested Capital (ROIC) of the Company and an increase in Earnings Before Interest, Depreciation and Amortisation (EBITDA) per case.

- In addition to above, sale of liquor manufactured/imported by USL has certain unique requirements which can be met only through specified suppliers. For example, the purchase of bulk scotch from other suppliers would face the below constraints acting as an impediment:

  - Liquid matching timeline – Matching liquid profile during transition from Whyte & Mackay to Diageo Scotland Limited took 3 years' time. As a result of the sale of W&M, most of the procurement processes of USL of bulk scotch had to be transitioned to DSL which resulted in significant time and efforts being incurred. Therefore, similar exercise and timeline would need to be invested;

  - Fragmented supplies – In case of Indian Made Foreign Liquor ("IMFL") and blended scotch, the Company may need to approach multiple producers for supply of scotch, in case a single supplier is unwilling to develop the complete portfolio.

- Continuity in supply of products: The raw materials have to undergo a rigorous process of blending, distilling, maturing, etc. before it attains the form of bulk scotch (which in turn acts as a raw material in the manufacture of alcoholic beverages). In this regard, the Group has in place best practices for various processes, including availability of facilities/sites for to produce the required quantities.

- Consumer preferences: The key to success for any alcoholic beverage is its taste and how it creates an impact on its user. Consumers tend to develop a specific taste and are often believed to be loyal to the brand of their preference. Understanding consumer behavior and preferences is critical for alcohol brands to stay competitive in a rapidly changing market. By keeping up with the latest trends in beverage types, packaging formats, and flavor profiles, Diageo group has been able to create products that resonate with its target audience and differentiate itself from its competitors. USL has been supplying these products in India for over a decade now. The volume sold and its market share is a testimony to the fact that products sold by USL are preferred by consumers. Any change in the product mix could have a severe impact on its revenue and market share.

2.4.1.3. Diageo group related synergistic benefits

Apart from the above, USL continues to benefit from certain business processes, policies and strategies of Diageo Group and the same has been briefly discussed below:

  - Consumer insights: The Group continuously involves its data tools to understand consumers' attitudes and motivations. This information is converted into data insights which enables the Group to respond with agility to consumers' interests and preferences.

- Marketing: The Group invests in world-class marketing to responsibly build vibrant brands that resonate with the consumers. It has a rigorous global marketing code and belongs to the Global Alliance for Responsible Media, working with peers to push for further consumer and brand safeguards.

- Distilling and brewing: The group distils, brews, bottles and distributes spirits and beer brands through a globally co-ordinated supply operation, working to the highest quality and manufacturing standards.

- Sourcing: From smallholder farms in Africa and Mexico to multinational companies, the Group works with suppliers to procure high-quality raw materials with environmental sustainability in mind.

- Innovation: Using the deep understanding of trends and consumer socialising occasions, the Group focuses on driving sustainable innovation that provides new products and experiences for consumers, whether they choose to drink alcohol or not.

- Selling: The Group grows by working closely with its customers. The sales teams use data, digital tools and insights, to extend sales reach, improve execution and help generate value for the Group and its customers.

2.4.2. Terms and conditions of the RPTs

As a manufacturer and distributor USL deals with Diageo group affiliates in line with general industry practice, wherein based on the customer preference and sales forecasts, it determines the required production volume, such that the supply to the consumers is not hampered. As part of the manufacturing activity, USL performs certain specific functions such as, identification and approvals for production unit, procurement planning, production scheduling, labelling, inventory management, logistics, quality control, marketing and sales. Further, as part of the distribution business, USL performs typical business functions like purchase, sales including managing the distribution channel relationships, marketing, invoicing and collection, warehousing, logistics etc. USL performs routine functions bearing routine business risks. It is not exposed to any adverse business risks like (IP infringement, R&D, quality, group reputation etc.).

The RPT policy adopted by USL is largely in line with the global TP policy of Diageo Group with respect to the abovementioned RPTs. As per the global TP policy of the Group, supply companies are entitled to a cost-plus arm’s length mark-up and the distributors are remunerated with an arm’s length distribution margin.

The pricing of the abovementioned arrangement has largely been consistent over the past several years. Further, as per the terms of the intercompany agreements, the credit period for payment towards purchases is 120 days.

2.4.3. Availing/rendering of any kind of service(s), or any other transaction(s) for transfer of resources, services or obligations and other reimbursements (‘Residual RPTs’).;

Entities within the Diageo group are party to a number of intercompany service transactions. The key service transaction categories include business shared services, management and consultancy services, information system support services, regional functions support and services, global procurement services, share scheme cost recharges, international assignee cost recharges, insurance recharges, and other back-office support services. As part of its routine business operations, USL may undertake either of the following transaction with DBBV. These transactions are largely initiated based on the business requirements.

Details of the reimbursement/ recovery of expenses anticipated to be undertaken during the year (not exhaustive) is given below:

- Additional clearance cost or delivery/ handling charges in respect of procurement;
- Demurrage or detention charges of material;
- Additional shipping cost or any other freight component;
- Additional cost of rework due to improper stacking, packaging or loading;
- Availing/ rendering service from registered global vendors of Diageo group, business shared services;
- Other general cost (e.g., travel, award, rent, electricity, other facility cost, etc.) recharges.

For the purposes of transfer pricing, all the above service categories can be characterized as routine services. The routine services are relatively low risk activities by virtue of the type of activities undertaken, the contractual relationship and pricing arrangements with the service recipients and are appropriately remunerated through a fee based on cost plus an appropriate mark-up.

Typically in an intra-group service transaction, owing to the synergies created in an intra-group setup, the group companies may exchange certain services including administrative/ business support services with each other. It is in common business parlance for group entities to enter into such arrangements for exchange of services so as to capitalize on the group synergies.

Generally, these services would be in relation to payment of employees’ salaries, payment of taxes, management and share-scheme cross-charges, administrative/ business support services. These services could be undertaken on either a cost-to-cost basis without any mark-up, or on a cost plus basis with an appropriate arm’s length mark-up.

Accordingly, the availing/ rendering of services by USL with DBBV for transfer of resources, services or obligations and other reimbursements typically qualify as intra-group services as highlighted above and the corresponding mark-up to be charged (if any) would be required to be determined based on arm’s length principles (refer ensuing sections for the benchmarking analysis).

2.4.4. Summary

As can be seen from above paragraphs, it is evident that the RPTs that shall be undertaken by USL with DBBV can be considered to be in ordinary course of business and at arm's length, protecting interest of minority shareholders and exhibiting economic benefit for all interested related parties. Further, as highlighted above, the pricing, financial arrangements and other commercial terms of the RPTs are comparable to those which an independent enterprise would enter into.

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3 Arm’s length analysis

3.1 Procurement of BIO brands for distribution

Companies comparables for the related party transaction would be companies which are engaged in the similar activity to the distribution function performed by USL. Further, such companies should themselves be independent and should not have significant controlled transactions, which could affect the arm’s length nature of their operating margins.

► Choice of methods - key consideration

The methods prescribed under the Income-tax Act, 1961, are applicable in the following scenarios:

► The CUP Method evaluates the “price” charged in a controlled transaction with reference to the “price” charged in comparable uncontrolled transactions, which could be identified either through internal or external comparables.

► The RPM is applicable in a resale situation, where the property or services purchased from an AE are sold to unrelated enterprise. The RPM is applied on either a transactional or a comparable-company basis, and it applies to distributors/marketers.

► CPM is generally applied in relation to supply of products or provision of services. CPM is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

► PSM may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions, which are so interrelated that they cannot be evaluated separately for the purpose of determining the ALP of any one transaction. The PSM is therefore appropriate for integrated transactions with more than one enterprise.

► TNMM is generally appropriate for the provision of services/ sale of goods where CPM or RPM cannot be adequately applied.

► Any method that takes into account the price that has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-AEs, under similar circumstances considering all the facts, shall be regarded as one of the recognized methods for determining the ALP.

The related party transaction under examination involves purchase of alcoholic beverages for resale in India. Accordingly, CUP and TNMM can be applied to determine ALP for such transaction.

Out of the above, CUP method cannot be applied in the present case due to non-availability of transaction level data through both internal and external sources of data.

Net margins earned by comparable companies performing activities similar to those of USL are available in the public domain and can be easily established, thus facilitating a more reliable comparability analysis. Further, it is a well-accepted principle that net margins are less affected by transactional differences than are prices. In this case, since the functions performed by comparables identified by us were broadly similar to the functions performed by USL, the TNMM, which involves net margin comparison, was considered as the most appropriate method for testing the arm's length price of bottled in origin brands transactions of USL.

- Search for comparable companies

Accordingly, companies engaged in trading of alcohol and alcohol-based products were considered as comparable to USL's business activities. To identify companies that could be considered as comparable to USL for analysing the above-mentioned related party transactions, we referred to two widely recognized databases using certain keywords which are comparable to USL. An illustrative list of the keywords used are given below:

List of keywords
Retail sale of alcoholic beverages
Retail sale of non-alcoholic beverages
Wholesale of intoxicants like wines and liquors
Retail sale in non-specialized stores with food, beverages or tobacco predominating
Beauty or make-up preparations and preparations for the care of the skin, other than medicaments
Perfumed bath salts and other bath preparations
Personal deodorants and anti-respirants
Wholesale of toiletry, perfumery and cosmetics

Post the keyword search, the companies were rejected for the following reasons based on financial data available on these public databases.

Rejection criteria
Insufficient Financial Information
Companies with no operations
Sick companies
Companies that had substantial (in excess of 25 percent) transactions with related parties
Companies with a turnover less than one crore

As the initial search criterion used was broad, we undertook a review of nature of service rendered by each company. Business descriptions, reports of Board of Directors, Management Discussion and Analysis, Auditor's Report, Accounting Policies and Notes to Accounts available in public domain and website information, wherever considered necessary, were examined to determine comparability.

Rejection criteria
Insufficient financial information
Significant related party transactions
Companies that were engaged in non-comparable functions
Companies that were engaged in non-comparable products
Tested Party
Duplicate Company
Insufficient Segmental Information
Persistent Operating Losses

Based on the Income-tax Rules, 1962 for determination of ALP in transfer pricing analysis, given that the number of comparable companies identified are more than 6, the arm's length range shall be beginning from the 35th percentile of the dataset and ending at the 65th percentile of the dataset as computed below.

A summary of operating margins for accepted companies is provided as follows:

35th Percentile	3.19%
Median	4.20%
65th Percentile	7.85%

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3.2 Procurement of Bulk scotch for manufacturing Diageo Brands in India (Bottled in India or BII brands) and USL brands.

Companies comparables for the related party transaction would be companies which are engaged in the similar activity to the manufacturing function performed by USL. Further, such companies should themselves be independent and should not have significant controlled transactions, which could affect the arm’s length nature of their operating margins.

- Choice of methods - key consideration

The methods prescribed under the Income-tax Act, 1961, are applicable in the following scenarios:

- The CUP Method evaluates the “price” charged in a controlled transaction with reference to the “price” charged in comparable uncontrolled transactions, which could be identified either through internal or external comparables.
- The RPM is applicable in a resale situation, where the property or services purchased from an AE are sold to unrelated enterprise. The RPM is applied on either a transactional or a comparable-company basis, and it applies to distributors/marketers.
- CPM is generally applied in relation to supply of products or provision of services. CPM is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.
- PSM may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions, which are so interrelated that they cannot be evaluated separately for the purpose of determining the ALP of any one transaction. The PSM is therefore appropriate for integrated transactions with more than one enterprise.
- TNMM is generally appropriate for the provision of services/ sale of goods where CPM or RPM cannot be adequately applied.
- Any method that takes into account the price that has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-AEs, under similar circumstances considering all the facts, shall be regarded as one of the recognized methods for determining the ALP.

The related party transaction under examination involves purchase of materials for manufacturing of alcoholic beverages. Accordingly, CUP and TNMM can be applied to determine ALP for such transaction.

Out of the above, CUP method cannot be applied in the present case due to non-availability of transaction level data through both internal and external sources of data.

Net margins earned by comparable companies performing activities similar to those of USL are available in the public domain and can be easily established, thus facilitating a more reliable comparability analysis. Further, it is a well-accepted principle that net margins are less affected by transactional differences than are prices. In this case, since the functions performed by comparables identified by us were broadly similar to the functions performed by USL, the TNMM, which involves net margin comparison, was considered as the most appropriate method for testing the arms length price for procurement of Bulk scotch for manufacturing BII brands and IMFL.

► Search for comparable companies

Accordingly, companies engaged in manufacture and sale of alcoholic beverages/ liquor were considered as comparable to USL's business activities. To identify companies that could be considered as comparable to USL for analysing the above-mentioned related party transactions, we referred to two widely recognized databases.

Post the keyword search, the companies were rejected for the following reasons based on financial data available on these public databases.

List of keywords
Manufacture of beer
Manufacture of country liquor
Manufacture of distilled, potable, alcoholic beverages such as whisky, brandy, gin, "mixed drinks" etc.
Manufacture of malt
Manufacture of malt liquors and malt n.e.c.
Manufacture of other non-alcoholic beverages n.e.c.
Manufacture of wines
Manufacture of soft drinks

Post the keyword search, the companies were rejected for the following reasons based on financial data available on these public databases.

Rejection criteria
Companies for which financial data was not available to undertake analysis
Sick companies
Companies that have turnover less than INR 1 crore
Companies that had substantial (in excess of 25 percent) transactions with related parties
No Operations

As the initial search criterion used was broad, we undertook a review of nature of service rendered by each company. Business descriptions, reports of Board of Directors, Management Discussion and Analysis, Auditor’s Report, Accounting Policies and Notes to Accounts available in public domain and website information, wherever considered necessary, were examined to determine comparability.

Rejection criteria
Companies for which sufficient financial/descriptive information was not available to determine comparability
Duplicate company
Insufficient segmental information
Negative Net worth
Significant related party transactions
Companies that were engaged in non-comparable functions
Companies that were engaged in non-comparable products
Companies that experienced persistent operating losses
Others

Based on the Income-tax Rules, 1962 for determination of ALP in transfer pricing analysis, given that the number of comparable companies identified are more than 6, the arm’s length range shall be beginning from the 35th percentile of the dataset and ending at the 65th percentile of the dataset as computed below.

A summary of operating margins for accepted companies is provided as follows:

35th Percentile	6.00%
Median	7.50%
65th Percentile	9.18%

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3.3 Availing/Rendering any kind of service(s), or any other transaction(s) for transfer of resources, services or obligations and other reimbursements ('Residual RPTs')

As per the OECD TP Guidelines, in trying to determine the arm's length price in relation to intra-group services, the matter should be considered both from the perspective of the service provider and from the perspective of the recipient of the service. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

For example, from the perspective of an independent enterprise seeking a service, the service providers in that market may or may not be willing or able to supply the service at a price that the independent enterprise is prepared to pay. If the service providers can supply the wanted service within a range of prices that the independent enterprise would be prepared to pay, then a deal will be struck. From the point of view of the service provider, a price below which it would not supply the service and the cost to it are relevant considerations to address, but they are not necessarily determinative of the outcome in every case.

► Choice of methods - key consideration

The methods prescribed under the Income-tax Act, 1961 are applicable in the following scenarios:

► The CUP Method evaluates the "price" charged in a controlled transaction with reference to the "price" charged in comparable uncontrolled transactions, which could be identified either through internal or external comparables.

► The RPM is applicable in a resale situation, where the property or services purchased from an AE are sold to unrelated enterprise. The RPM is applied on either a transactional or a comparable-company basis, and it applies to distributors/marketers.

► CPM is generally applied in relation to supply of products or provision of services. CPM is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

► PSM may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions, which are so interrelated that they cannot be evaluated separately for the purpose of determining the ALP of any one transaction. The PSM is therefore appropriate for integrated transactions with more than one enterprise.

► TNMM is generally appropriate for the provision of services/ sale of goods where CPM or RPM cannot be adequately applied.

► Any method that takes into account the price that has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-AEs, under similar circumstances considering all the facts, shall be regarded as one of the recognized methods for determining the ALP.

The related party transaction under examination involves availing and rendering of services. Accordingly, CUP and TNMM can be applied to determine ALP for such transaction.

Out of the above, CUP method cannot be applied in the present case due to non-availability of transaction level data through both internal and external sources of data.

Net margins earned by comparable companies performing activities similar to those of USL are available in the public domain and can be easily established, thus facilitating a more reliable comparability analysis. Further, it is a well-accepted principle that net margins are less affected by transactional differences than are prices. In this case, since the functions performed by comparables identified by us were broadly similar to the functions performed by USL, the TNMM, which involves net margin comparison, was considered as the most appropriate method for testing the above-mentioned transaction of USL.

► Search for comparable companies

Companies comparables for the related party transaction would be companies which are engaged in the similar activity to the services received/ performed by USL. Further, such companies should themselves be independent and should not have significant controlled transactions, which could affect the arm's length nature of their operating margins.

Accordingly, companies engaged in receipt/ provision of support services were considered as comparable to USL's business activities. To identify companies that could be considered as comparable to USL for analysing the above-mentioned related party transactions, we referred to two widely recognized databases.

Post the keyword search, the companies were rejected for the following reasons based on financial data available on these public databases.

List of keywords
Accounting, bookkeeping and auditing activities
Other business support service activities n.e.c.
Other information service activities n.e.c.
Other specialised office support services activities
Providing data entry services

Post the keyword search, the companies were rejected for the following reasons based on financial data available on these public databases.

Rejection criteria
Insufficient Financial Information
Companies with no operations
Sick companies
Companies that had substantial (in excess of 25 percent) transactions with related parties
Companies with a turnover less than one crore

As the initial search criterion used was broad, we undertook a review of nature of service rendered by each company. Business descriptions, reports of Board of Directors, Management Discussion and Analysis, Auditor's Report, Accounting Policies and Notes to Accounts available in public domain and website information, wherever considered necessary, were examined to determine comparability.

Rejection criteria
Insufficient financial information/Insufficient descriptive information
Significant related party transactions
Companies that were functionally different
Companies that were engaged in non-comparable services
Companies which had persistent operating losses
Companies which have No Operation
Companies that were duplicated in the database
Companies with insufficient segmental information to perform analysis

Based on the Income-tax Rules, 1962 for determination of ALP in transfer pricing analysis, given that the number of comparable companies identified are more than 6, the arm's length range shall be beginning from the 35th percentile of the dataset and ending at the 65th percentile of the dataset as computed below. A summary of operating margins for accepted companies is provided as follows:

35th Percentile	4.20%
Median	7.73%
65th Percentile	12.97%