Pass-Through Costs in Transfer Pricing

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Introduction

Ever since transfer pricing (TP) regulations have been introduced under the Income-tax Act, 1961, vide Finance Act, 2001 one can observe continuous increase in the TP adjustments made by the Income-tax department. The TP adjustments in 2005-06 amounted to INR 1,220 crores and in the year 2014-15 amounted to INR 46,666 crores after peaking to INR 70,016 crores in the year 2012-13. There have been various petitions before the Central Government for more clarity on transfer pricing provisions by the industry. The current Government has taken positive steps in this regard, for example, the introduction of arm's length range concept in the Indian transfer pricing regulations vide Rule 10CA of the Income-tax Rules, 1962.

The exercise of complying with the transfer pricing regulation is an art as well as a science. The method chosen for benchmarking a related party transaction from the list given as per the provisions of Sec. 92C depends on the facts of the case. There are various concepts under each prescribed method which can be applied to a situation to make the benchmarking process more meaningful. It is often observed that the Transaction Net Margin Method (TNM Method) is one of the most commonly used method for benchmarking. In this Article we will be discussing the concept of pass-through costs which can be applied in a transfer pricing exercise where transaction net margin method is used.

Generally, the TNM Method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. Thus, a transaction net margin method operates in a manner similar to the cost plus method and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, i.e. by reference to "internal comparables". Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. Further, the other requirements for comparability must be applied as mentioned in Paragraphs 2.68-2.75 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines).

OECD view on TNM Method and Pass-through Costs

In applying the TNM Method taxpayers adopt the Net Profit as the numerator which is weighted against either assets, sales, or costs (denominator). As per the OECD TP Guidelines only those items that (a) directly or indirectly relate to the controlled transactions at hand

and (b) are of an operating nature should be taken into account in the determination of the net profit indicator for the application of the transactional net margin method. As far as the selection of denominator goes, it should be consistent with the comparability (including functional) analysis of the controlled transaction, and in particular it should reflect the allocation risks between the parties (provided said allocation of risk is arm's length). For instance, capital-intensive activities such as certain manufacturing activities involve significant investment risk even in those cases where the operational risks (such as market risks or inventory risks) might be limited. Where a TNM Method is applied to such cases, the investment-related risks are reflected in the net profit indicator if the latter is a return on investment (e.g. return on assets or return on capital employed). Such indicator might need to be adjusted (or a different net profit indicator selected) depending on what party to the controlled transaction bears that risk, as well as on the degree of differences in risk that may be found in the taxpayer's controlled transaction and in comparables.

The denominator should be focused on the relevant indicator(s) of the value of functions performed by the tested party in the transaction under review, taking account of its assets used and risks assumed. Typically, and subject to a review of the facts and circumstances of the case, sales or distribution operating expenses maybe an appropriate base for distribution activities, full costs or operating expenses base for a service or manufacturing activity, and operating assets maybe an appropriate base for capital-intensive activities such as certain manufacturing activities or utilities. Other bases can also be appropriate depending on the circumstances of the case.

While adopting the TNM Method we have discussed the net profit (numerator) can be weighted to either assets, sales or costs (denominator). Pass-through costs gain relevance when under TNM Method the Net Profit is weighted to costs. As per the OECD TP Guidelines net profit should be weighted to costs only in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that directly or indirectly relate to the controlled transaction under review should be taken into account. Accordingly, an appropriate level of segmentation of a taxpayer's accounts is needed in order to exclude from the denominator costs that relate to other activities or transactions and materially affect comparability with uncontrolled transactions. Moreover, in most cases only those costs which are of an operating nature should be included in the denominator.

In applying a cost-based TNM Method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. The question can arise whether and to what extent it is acceptable at arm's length to treat a significant portion of the taxpayer's costs as pass-through costs to which no profit element is attributed (i.e. as costs which are potentially excludable from the denominator of the net profit indicator). This depends on the extent to which an independent party in comparable circumstance would agree not to earn a mark-up on part of the costs it incurs. The response should not be based on the classification of costs as “internal” or “external” costs, but rather on a comparability (including functional) analysis. (Para 2.93 of the OECD TP Guidelines)

Where treating expenses as pass-through costs is found to be at Arm’s Length, a second question as to the consequences on comparability and on the determination of the arm’s length range. Because it is necessary to compare like with like, if pass-through costs are excluded from the denominator of the taxpayer’s net profit indicator, comparable costs should also be excluded from the denominator of the comparable net profit indicator. Comparability issues may arise in practice where limited information is available on the breakdown of the costs of the comparables.

<u>Pass – Through Costs in Indian Transfer Pricing Scenario</u>

In the Indian TP Regulations, there has been no reference made to the treatment of the pass-through costs. However, the Indian judiciary has made a reference to the concept of pass-through costs which is in accordance with the OECD view in several case laws. In this article the author has discussed to case laws the first being where the assesse is an advertising agency service provider and the second case law covers a situation of an assesse being a contract manufacturer.

1. **Deputy Commissioner of Income-tax vs. Cheil Communications India (p) ltd., (2010) 29 CCH 0853 DelTrib**
   In this case law the Hon’ble Delhi Tribunal held observed as follows, *the assessee has applied TNM method to determine arm’s length price, which has also been accepted by the Revenue authorities. The comparables cited by the assessee has also been accepted by the TPO as appropriate. It is also found that in the regular financial accounts maintained by the comparable companies, the comparables recognize revenue on a net basis. The assessee has also recognized revenues on a net basis in its financial account, which had been duly audited by the auditor. The assessee has computed the margin of operative profit on the total cost on the basis of net revenue by way of mark-up received from the associate concern. The payment made by the assessee to third party vendor/media agencies for and on behalf of the principal has not been included in the total cost for determining the profit margin, though, on the other hand, the TPO has included the payment reimbursed by the assessee’s associate enterprise to the assessee on account of payment made to third party vendor/media agencies. It is not in dispute that the assessee is engaged in undertaking advertising services for its customers/AEs in the capacity of an agent. As part of its business operation, the assessee facilitates placement of advertisement for its associated enterprise in the print/electronic etc. media and for that purpose, the assessee is required to make payment to third parties for rendering of advertisement space on behalf of its customers or associated enterprises. It is, thus, clear that the assessee’s business is not sale of advertising slots to its customers or associate concern. For performing the functions for and on behalf of associated enterprises, the assessee is remunerated by its associated enterprises on the basis of a fixed commission/charges based on expenses or cost incurred by the assessee for release of a particular advertisement. It is also to be noted that advertising space (be it*

media, print or outdoor), has been let out by third party vendors in the name of ultimate customers and beneficiary of advertisement. The invoices and purchase orders from third party vendors contain customers' name, and all the terms of advertisement are finalized after taking the approval from the customers. The assessee simply acts as an intermediary between the ultimate customer and the third party vendor in order to facilitate placement of the advertisement. The payment made by the assessee to vendors is recovered from the respective customers or AEs. In the event customer fails to pay any such amount to the advertisement agency, the bad debt risk is borne by the third party vendor and not by the advertising agency i.e. the assessee. It is, thus, clear that the assessee has not assumed any risk on account of non-payment by its customers or associated enterprises. As per ITS 2009 Transfer Pricing Guidelines accepted by the OECD, when an AEs is acting only as an agent or intermediary in the provision of service, it is important in applying the cost plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves, and, in such a case, it may be not appropriate to determine ALP as a mark-up on the cost of services but rather on the cost of agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than that would be appropriate for the performance of the services themselves. In these type of cases, it will be appropriate to pass on the cost of rendering advertising space, to the credit recipient without a mark-up and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function. In the light of ITS 2009 Transfer Pricing Guidelines, it would be clear that a mark-up is to be applied to the cost incurred by the assessee company in performing its agency function and not to the cost of rendering advertising space on behalf of its AEs. Further, the method adopted by the assessee while submitting transfer pricing study based on net revenue has been accepted by the Department in earlier year and, therefore, there is no reason to depart from that stand already accepted by the Department in earlier year.

2. **Johnson Metthey India Private Limited vs. Deputy Commissioner of Income-tax, (2015) 94 CCH 0067 DelHC**

   The background facts are that the Assessee Johnson Matthey India Private Limited ('JMIPL') is engaged in the business of manufacture and sale of automobile exhaust catalysts. 90% of the shares of the Assessee Company are held by **Johnson Matthey** Plc. UK ('JMUK') through Matthey Finance, BV, Netherlands. JMIPL's manufacturing unit is located at IMT, Manesar in Haryana. Maruti Udyog Limited ('MUL') is a major customer of JMIPL accounting for most of its sales.

   The Delhi High Court with reference to the assessee's plea on the grounds of the concept of Pass-through costs ruled in favour of the assesse and made the following observation, *the clauses of the agreement between JMIPL and MUL which have been extracted hereinbefore indicate that JMIPL's profit margin is dictated by its negotiations with MUL. The clauses do bear out the submission of JMIPL that it is obliged to procure the raw material on instructions of MUL at a price dictated by MUL from the source selected by MUL. JMIPL is entitled to a per unit fixed* *manufacturing charge over and above the actual cost of the raw material. The submission of JMIPL that entire cost of raw materials comprising of precious metals and substrates is passed on to or recovered from the ultimate customer without any mark-up has not been able to be countered by the Revenue. In other words, the contention of JMIP that its profit is not at all affected by the cost of raw materials remains uncontested. The submissions of the Revenue as to what are true pass through costs fail to acknowledge the actual arrangement between JMIPL and MUL as reflected in the clauses of the agreement as well as in other documents and letters placed on record.*

Conclusion

The Transfer Pricing audit season is once upon us as we approach the November 31st deadline. There are numerous concepts in the science of transfer pricing where adjustments can be made to the Arm's Length Price to make the comparison more meaningful. In this article, we have discussed one of those lesser known adjustments possible, as India is host to a multitude of outsourced manufacturing facility of global multinationals owing to our keen price advantage. The concept of pass-through cost might find application in such cases during the transfer pricing exercise.