



Workshop on Transfer Pricing

Resale Price Method – Overview and Practical Issues

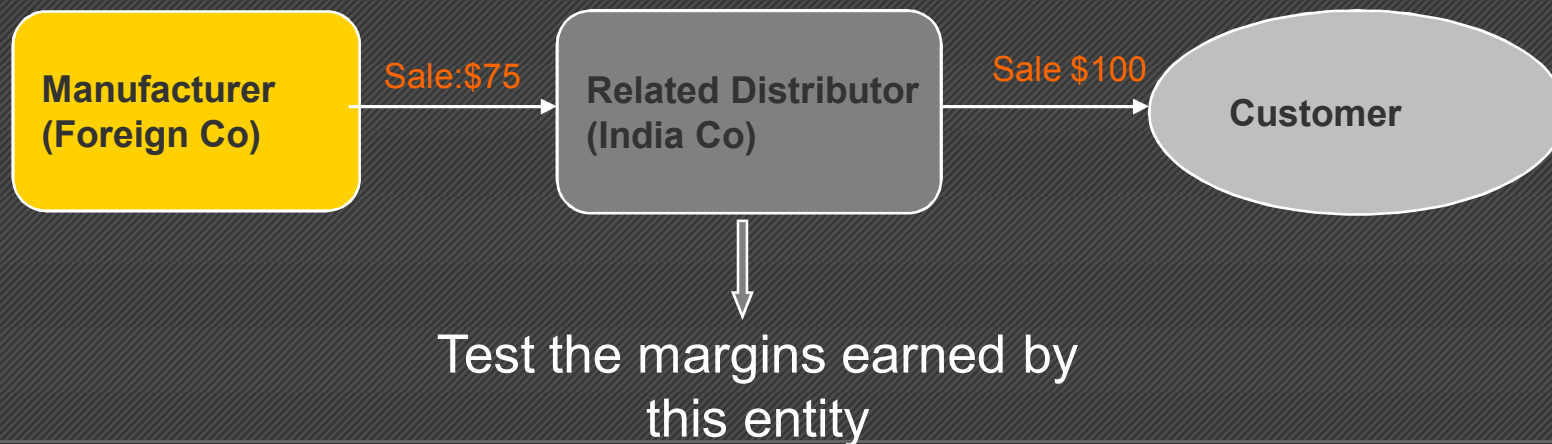
3 November 2009

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RPM – An overview

- ▶ Governed under Rule 10B(1)(b);
- ▶ Strictly interpreted as transaction-based method;
- ▶ Not applicable if reseller adds significant value;
- ▶ Reseller earns same gross margin as uncontrolled comparable resellers;
- ▶ Transfer price is reseller's price to third party minus comparable reseller's gross margin;



RPM – Rule 10B(1)(b)

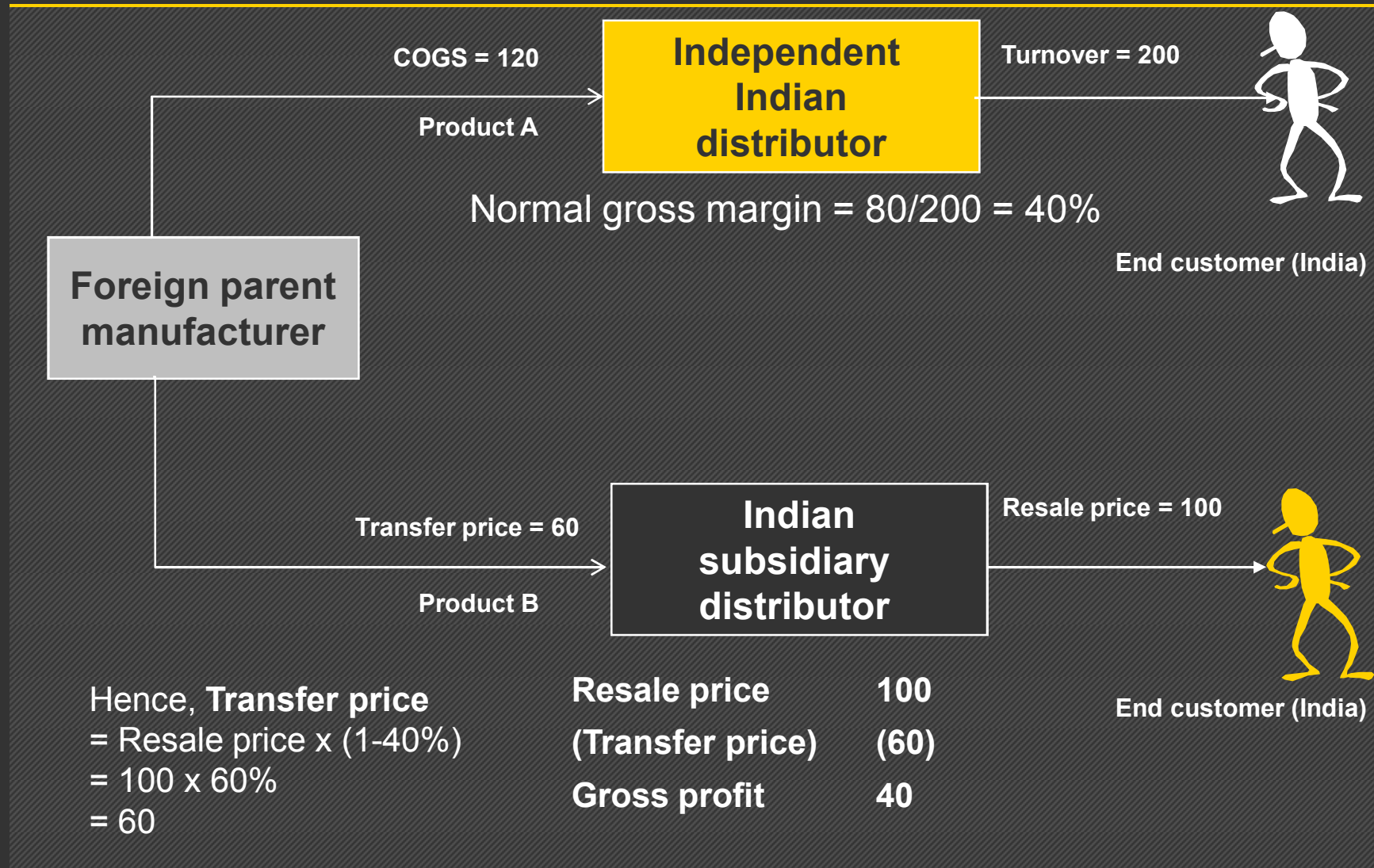
- ▶ The price at which property purchased or services obtained from a AE is resold or provided to an unrelated enterprise is identified;
- ▶ Such resale price is reduced by the amount of a normal gross profit margin..., in a comparable uncontrolled transaction;
- ▶ The price so arrived is further reduced by the expenses incurred by the enterprise in connection with the purchase...;
- ▶ The price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, which could materially affect the amount of gross margin in the open market...;

Comparability Factors

- ▶ **Functional Comparability:**
 - ▶ Similar functions, risks and contractual terms;
 - ▶ More likely to find similar characteristics among different sales by the same controlled party than among sales made by other sellers.

- ▶ **Adjustments under RPM for material differences:**
 - ▶ Inventory levels and turnover rates;
 - ▶ Sales, marketing and advertising programs;
 - ▶ The level of market (i.e. wholesale or retail);
 - ▶ Accounting practices;
 - ▶ Use of Tangible or Intangible assets;
 - ▶ Foreign currency risks; and
 - ▶ Contractual terms (i.e. pricing, warranty, credit, volume terms)

Case Study 1



Case Study 1

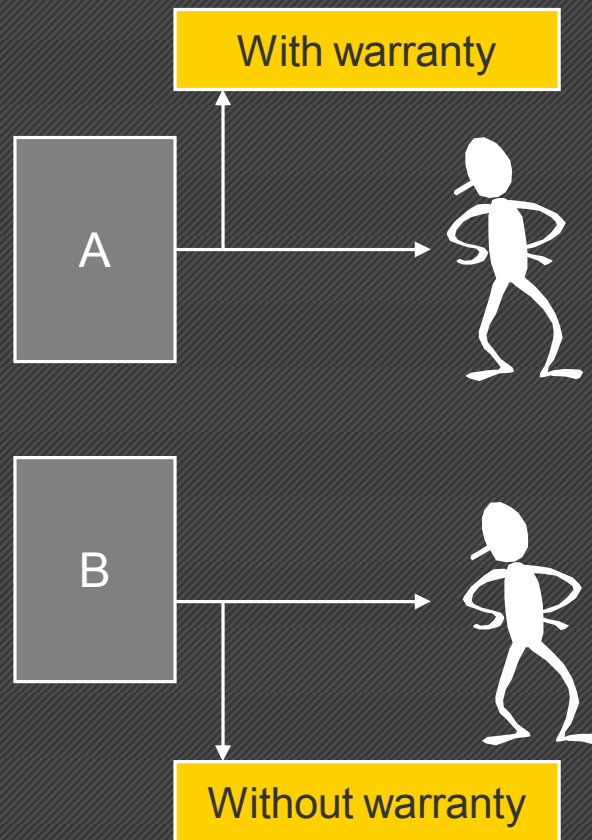
▶ Computation mechanism

Actual resale price from sale to unrelated enterprises	A	100
Less: Comparable gross profit margin	B	40
Cost of Sales (A-B)	C	60
Add: Tested Party's Stock Adjustment	D	0
Less: Expenses related to the purchase from group companies	E	0
Arm's length price determined under RPM rule (C+D-E)	F	60

▶ +/-5% allowance

Case Study 2

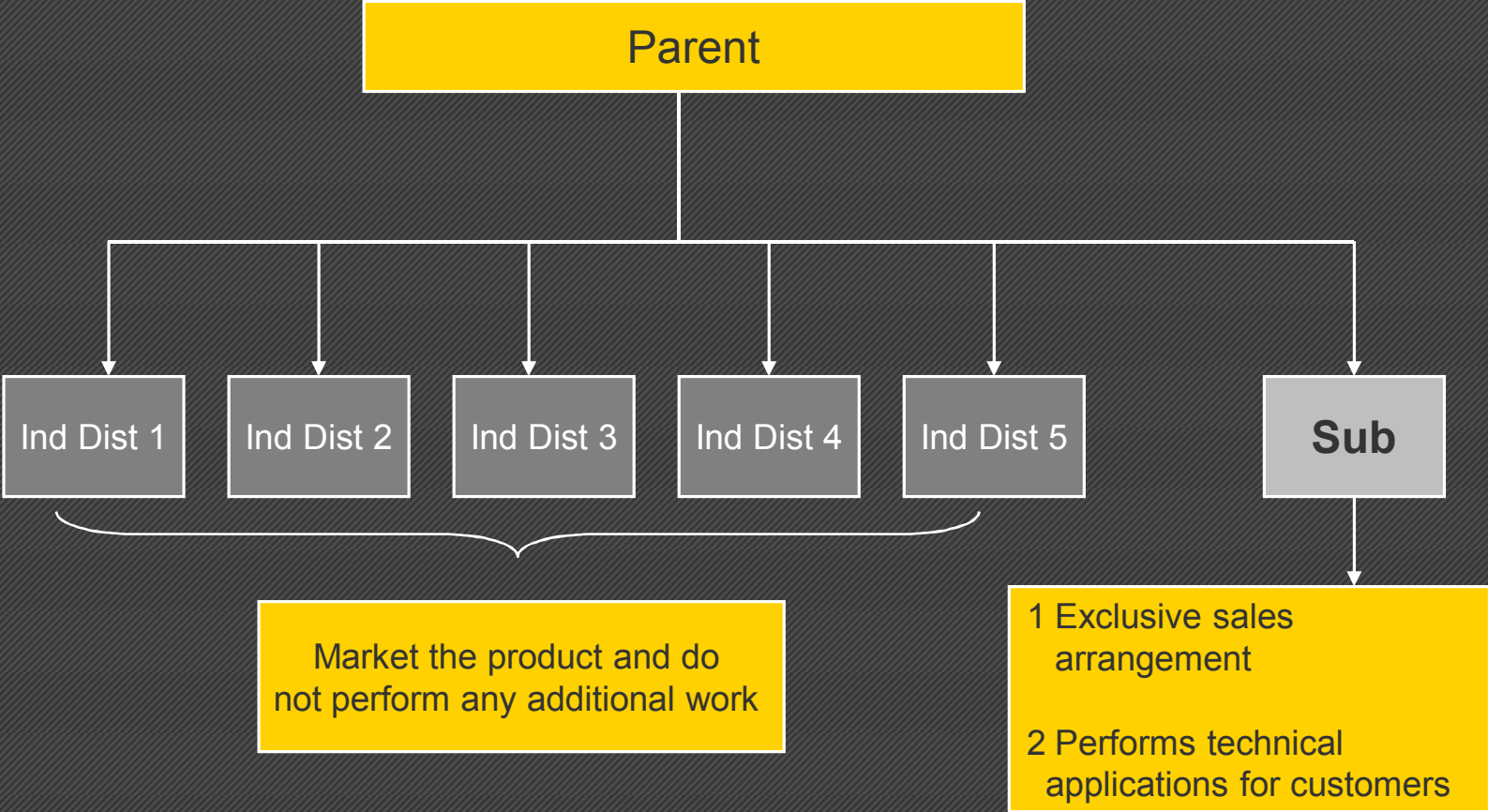
▶ Contractual Terms Adjustments



- ▶ Two distributors selling in the same market under the same brand name
- ▶ Distributor A offers a warranty; Distributor B offers none.
- ▶ If the warranty expenses are accounted as operating expenses, there is a distortion in the gross margins which must be adjusted

Case Study 3

▶ Sales & Marketing & Additional Functions



Case Study 4

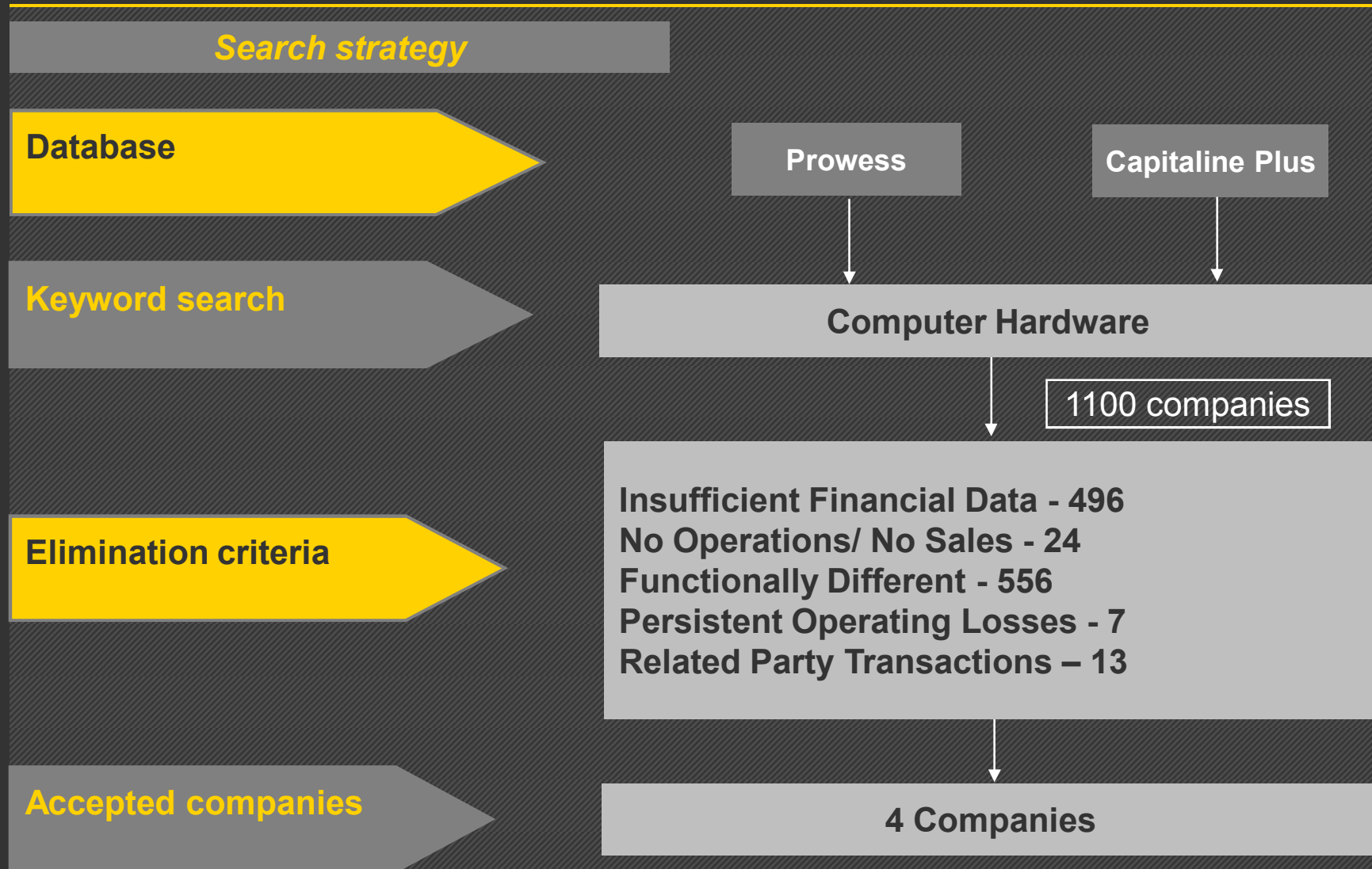
▶ Facts

- ▶ XYZ Group is one of the world's leading and fastest growing lifecycle engineering IT solutions and services provider to the process and power industries
- ▶ XYZ India is engaged in the distribution of XYZ Group's hardware products in India
- ▶ XYZ India is a risk bearing entrepreneurial entity and carries on routine distribution functions
- ▶ XYZ group holds all significant IPRs and undertakes limited functions such as handling customer complaints, pricing decisions and framing advertisement and marketing strategies

Case Study 4

- ▶ Financial information
 - ▶ Sales – Rs 150,000,000,
 - ▶ Opening stock – 13,000,000, Closing stock – 14,000,000
 - ▶ Purchase value – 70,000,000, Customs & other expenses – 18,000,000

Case Study 4



Case Study 4

Summary of gross margins and computation of ALP

<i>All amount in Rs 000's</i>							
Comp	WA GP on Net Sales (%)	Sales value of XYZ India to unrelated parties (A)	AL GP (B=A x WA Gross Margin)	AL COS (C = A - B)	Tested Party's Stock Adj (D) [Closing - opening]	Adj for other expenses included in COS (E)	ALP for products procured from group companies (F= C+D-E)
1	25.41%	150,000	38,112	111,888	10,000	18,000	103,888
2	37.45%	150,000	56,173	93,827	10,000	18,000	85,827
3	2.96%	150,000	4,444	145,556	10,000	18,000	137,556
4	11.22%	150,000	16,827	133,173	10,000	18,000	125,173
AM	19.26%	150,000		121,111			113,111

Case Study 4

Conclusion

- ▶ Purchase price of XYZ India was Rs 70,000,000
- ▶ Based on the RPM analysis, the arm's length price was determined at Rs 113,110,978
- ▶ The price paid by XYZ was determined to be at arm's length as it was lower than the arm's length price

Practical issues in RPM Analysis

- ▶ Gross margins are affected by minor functional differences
- ▶ Difficulties in proper application, particularly in determination of costs
 - ▶ Difficult to find accurate data disclosing gross margins of independent resellers in public domain
 - ▶ Categorization of expenses as operating expenses or cost of goods sold may be subject to manipulation
 - ▶ Differences in accounting policies, operational efficiency, economies of scale, etc would be difficult to adjust
 - ▶ Difficulties in benchmarking limited risk distributor
- ▶ Lack of guidance for reliable adjustments



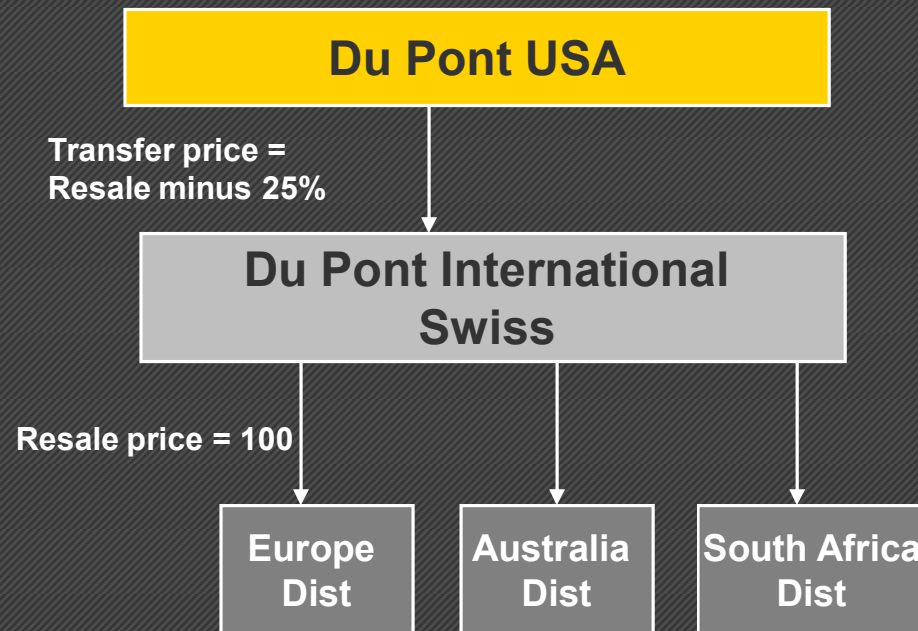
Use of RPM in International Context and Practical Issues

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Du Pont Case

E.I. Du Pont De Nemours and Company v The United States



- Case pertains to years 1959 and 1960
- DISA is a Swiss marketing and distribution company for Du Pont
- Most of Du Pont chemical products sold to DISA for onward sale internationally

Du Pont Case

- ▶ Functions performed by DISA
 - ▶ European presence for DuPont
 - ▶ Market research, marketing consulting, and advertising in Europe
 - ▶ Technical service function
 - ▶ Logistics and accounting functions for product shipped directly by Du Pont
 - ▶ Inventory management and full-fledged distribution function including purchasing, warehousing, sales & marketing, invoicing and collection
- ▶ Du Pont's pricing formula was intended to insulate DISA from losses on sales. DISA has minimal risks as compared to the independent distributors
- ▶ Du Pont selected the Resale Price Method for determining the arm's length price; no adjustments for the differences

Du Pont Case

▶ Judgment

- ▶ DISA characterized as providing services analogous to those provided by a combination of a market research and management consultant, an advertiser, and a distributor
- ▶ Berry Ratio applied by comparing DISA's ratio of gross profit to SG&A expenses to the third-party comparables' ratio of gross profit to SG&A expenses
- ▶ Berry Analysis revealed that DuPont had compensated DISA for its services at a level that was significantly above arm's length terms

▶ Takeaways

- ▶ If RPM is considered, comparables to satisfy comparability criteria
- ▶ Use of Berry Ratio to make adjustments to improve reliability of RPM analysis

Berry Ratio – Conceptual Overview

- ▶ Concept of berry ratio
 - ▶ Developed by Prof Charles Berry
 - ▶ Determines the profitability of an enterprise on account of distribution services/ value added costs
 - ▶ Calculated as a percentage of gross margin on operating expenses (SG&A expenses)
 - ▶ Coefficient more than 1 - firm is profitable; less than 1 – suggests that it is loss making
- ▶ Used for service providers and for routine or pure distributors

Uses of berry ratio

- ▶ Merits
 - ▶ Best applicable to test routine distributors
 - ▶ Represents a return on company's value added functions - measures the mark-up earned by distributor's distribution activities
 - ▶ Can be applied to both distributors and service providers
 - ▶ Reliable tool which can be employed to determine arm's length results not only for certain sales-related activities, but for any activity
 - ▶ Makes comparison possible when there are different operating expenses
 - ▶ Broader range of comparables could be used
 - ▶ Reduces numerous adjustments for differences in specific operating expenses

Case study 5 – Application of Berry ratio

	Comparable Set A	Comparable Set B	Controlled distributor
Net Sales	\$100,000	\$120,000	\$110,000
COGS	\$70,000	\$96,000	??
Gross Profit	\$30,000	\$24,000	??
Operating (SG & A) Expenses	\$25,000	\$18,000	\$22,000
Operating Income	\$5,000	\$6,000	??
Unadjusted GP Margin	30%	20%	??
Operating Expenses/Sales	25%	15%	20%
Operating Profits/Sales	5%	5%	??
Berry Ratio	1.2	1.33	
Berry Ratio times SG&A	\$26,200	\$29,333	
Adjusted GP Margin	24%	26.67%	

Case study 5 – Application of Berry ratio

Use of unadjusted GP Margin on Controlled Distributor's results

	Controlled distributor with A gross margins	Controlled distributor with B gross margins
Net Sales	\$110,000	\$110,000
COGS	\$77,000	\$88,000
Gross Profit	\$33,000	\$22,000
Operating (SG & A) Expenses	\$22,000	\$22,000
Operating Income	\$11,000	\$0
COGS/Sales	70%	80%
Operating Expenses/Sales	20%	20%
Gross Profit/Sales	30%	20%
Operating Profits/Sales	10%	0%

Case study 5 – Application of Berry ratio

Use of Berry adjusted GP Margin on Controlled Distributor's results

	Controlled distributor with A gross margins	Controlled distributor with B gross margins
Net Sales	\$110,000	\$110,000
COGS	\$83,600	\$80,663
Adj Gross Profit	\$26,400	\$29,337
Operating (SG & A) Expenses	\$22,000	\$22,000
Operating Income	\$4,400	\$7,337
COGS/Sales	76%	73.3%
Operating Expenses/Sales	20%	20%
Adj Gross Profit/Sales	24%	26.67%
Operating Profits/Sales	4%	6.67%

Limitations of berry ratio

- ▶ Limitations
 - ▶ Cannot be applied to integrated distributors (i.e. distributors that also perform manufacturing or assembly functions)
 - ▶ Assumes correlation between operating expenses and capital requirements
 - ▶ Differences in operating assets between tested party and comparables not factored
 - ▶ Differences in contractual terms (such as payment terms) not factored
 - ▶ Requires use of operating expense intensity screening to avoid distortions arising from abnormal Berry ratios

Summary and conclusions

- ▶ Remains second in the hierarchy of methods (next only to CUP)
- ▶ Preferred method for distributors/ resellers while certain practical difficulties exist
- ▶ Reliability enhanced on undertaking appropriate adjustments
- ▶ Additional guidance required for undertaking reliable adjustments in Indian context
- ▶ Berry ratio as an alternative tool for benchmarking adjusted gross margins

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Fact file

Education	Chartered Accountant; Bachelors in Commerce
Specialty areas	International Tax Transfer Pricing Supply chain planning Cross border structuring

Experience

- ▶ Pramod has over 12 years of professional experience as Indian tax advisor.
 In last couple of years, Pramod led the Indian Tax Desk based out of San Jose, USA and served the Ernst & Young's North American clientele on Indian transfer pricing and tax issues. Before joining the US practice to set up India tax desk, Pramod worked with Ernst & Young's Transfer Pricing practice and supervised several large international tax structuring and transfer pricing projects out of Bangalore, Hyderabad and Chennai.
- ▶ He served a wide range of Indian and global companies in different industry verticals during his career. He advised clients on Indian ownership structures, tax efficient financing, and repatriation structures for doing business in India.
- ▶ His experience includes Indian planning for IP licensing structures, transfer pricing design and tax-efficient supply chain structures in India. He has also been involved in Indian mergers and acquisitions (M&A) planning and group re-structuring projects for many years.
- ▶ He has considerable experience in advising companies on transfer pricing planning, documentation and controversy management.