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Pass through costs - 4 key principles and practical scenarios

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Transactional Net Margin Method (TNMM) is still the most commonly used method in India. Over the years we have seen that application of TNMM has evolved from use of traditional Profit level indicators (PLI s) such as Operating Profit to Sales and Operating Profit to Total Costs to different PLIs such as Cash PLI, berry ratio, return on capital employed etc. One such PLI has been the use of Operating Profit / Value added expense (VAE) where VAE is Total costs minus pass through costs. This article explains the concept of pass through costs and the principles emanating from the Indian judicial precedents till date.

Concept:

As per the Indian Transfer Pricing Regulations (ITPR), TNMM is determined with reference to the net profit margin realized by the enterprise computed in relation to costs incurred, sales effected or assets employed by the enterprise or having regard to any other relevant base. There is no specific guidance available in ITPR on the definition of costs / relevant base while computing the operating margins. However the Guidance note on transfer pricing specifies certain ratios that can be used while applying TNMM such as the Berry ratio. This implies that OP/VAE, being a variant of Berry ratio can be an acceptable PLI.

The pass through costs are expenses which are incidental or ancillary to the primary business activity of a taxpayer and in respect of which the taxpayer neither performs any significant functions nor assumes any risks. In such cases while using a cost based TNMM, these costs should be excluded from the costs while computing the operating profit to total costs ratio.

As per OECD TP guidelines[1] whether certain costs (to which no profit element is attributed) can be treated as pass through costs or not will depend on the extent to which an independent party in comparable circumstances would agree not to earn a mark-up on part of costs it incurs. Also, if pass through costs are to be excluded while computing operating margins of the taxpayer, comparable costs should also be excluded while computing the operating margins of the comparables.

Judicial precedents:

Cheil India[2] was the first ruling in India on this issue. Based on the facts of the case and relying on the OECD guidelines, the ruling allowed exclusion of pass through costs while applying TNMM. The decisions

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from the subsequent rulings have been provided below:

Ruling	Transaction /Issue	Whether costs allowed as pass through costs?
Johnson Matthey India Private Limited[3] (Delhi HC)	Raw material is procured by the taxpayer under the instructions and at the price decided by the customer The cost of raw material was reimbursed separately, over and above a fixed manufacturing charge	Yes
McDonalds India (P) Ltd[4]	Assessee was collecting royalty and franchise service fees from JVs based on the sub-licensing agreement and remitted it to its AE as per the Master License Agreement	Yes
Akon Electronics India Pvt Ltd[5]	The assessee purchased kits as raw material from its AE and sold it back to AE after assembling and partial testing	Yes
Fritidsresor Tours & Travels India Pvt. Ltd [6] (Delhi HC)	The overseas AE of the assessee enters into contracts with tourists for their outbound tours to India. The assessee organizes the tours in India and raises bills on the AE	No The taxpayer charged all-inclusive composite fees to its AE irrespective of actual costs incurred. The third party costs such as hotel bookings were incurred on its own account.
M/s Lason India Pvt. Ltd[7]; Fujitsu India Ltd[8]; M/s Applied Materials India Pvt. Ltd[9]; and M/s Kobelco Cranes India Pvt. Ltd[10].	Whether costs incurred for business activities such as subcontracting expenses and commission paid to third parties could be treated as pass through costs	No The costs were incurred by the taxpayer on its own account.

Key Principles based on Indian judicial precedents:

The judicial precedents are consistent with OECD guidelines that a taxpayer cannot be expected to earn a return on pass through costs. However, pass through costs can be allowed only if the taxpayer is able to prove that there were no functions performed or risks assumed relating to these costs and it was merely acting as a facilitator. If it is observed that the assessee had incurred costs on its own account, the argument of pass through costs has been rejected.

The key principles emanating from the various rulings have been summarized below:

- Pass through costs are those expenses which are incidental or ancillary to the primary business activity of a taxpayer and in respect of which the taxpayer typically neither performs any significant functions nor assumes any risks thereof;

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- The pass through costs should not include any profit element and should be separately recoverable as per the remuneration model;

- The expression any other relevant base mentioned in Rule 10B(1)(e)(i), allows a denominator that excludes pass through costs;

- Pass through costs should not be considered as a part of operating costs, while computing the operating profitability.

Practical cases:

- ABC Ltd acts as a contract manufacturer for its AE, XYZ Ltd. As per the contract, ABC Ltd procures certain raw material from vendors identified by XYZ limited under the instructions and as per the price agreed by XYZ Ltd. XYZ Ltd agrees to reimburse the cost of such raw material procured at actuals and a mark-up on the value added expenses.

This is similar to the case of Johnson Matthey India Private Limited, discussed above. In this case, all the procurement related functions are done by XYZ Ltd. The arrangement also demonstrates the fact that there is no profit relating to the raw material in the final selling price. Accordingly, the raw material costs in this case should be treated as pass through costs. Further, the assessee should be mindful that in such cases, the purchases may qualify as deemed international transactions and may need to be reported in the Accountant s report.

- In the above example, let s assume that the raw material is procured by ABC Ltd from suppliers approved by XYZ Ltd. However, the price negotiations with such suppliers are done by ABC Ltd. XYZ Ltd agrees to pay ABC Ltd a fixed price for the finished goods.

In this case, one of the key functions relating to procurement i.e. price negotiations is done by ABC Ltd. Also since the sales price is fixed, it cannot be concluded that there is no profit element which in relation to the raw material procured. In such a case, the raw material costs may not be allowed as pass through costs.

- In case of an assessee providing procurement support services to its AE and getting remunerated on a cost plus basis, if merely for administrative convenience the purchases from third party vendors are routed through the books of the assessee, then the purchases costs can be treated as pass through costs.
- In case of a routine cost plus software service provider say ABC Ltd, if ABC Ltd makes payments for travel, hotel booking costs on behalf of the AE during the visits to India by their employees and recovers these separately as reimbursements, then ABC Ltd should not be expected to include such costs as a part of total costs while computing the mark up.

An important point which should be considered in all cases where certain costs are treated as pass through costs is that if the taxpayer ends up blocking working capital due to such pass through costs, then interest on such working capital should be factored in while computing the arm s length price.

Conclusion:

As per the judicial precedents, whether costs can be treated as pass through costs is a fact specific exercise and the onus is on the taxpayers to demonstrate why the costs should be allowed as pass through costs. The taxpayers are advised to document a detailed functional, asset and risk analysis to substantiate that it is only acting as a facilitator in relation to such costs. The intercompany agreements should clearly document that it does not perform any functions or assume any risks in relation to such costs and the basis of remuneration in such cases should be a mark-up on value added costs only.

As transfer pricing in India continue to evolves, the disputes will continue whether certain costs can be treated as pass through costs in different scenarios. Such costs will need to pass the test of principles laid as per OECD guidelines and judicial precedents to be treated as pass through costs. Considering the materiality and to avoid litigation at lower levels, the taxpayers can evaluate applying for an advance pricing agreement and get certainty based on the specific facts of the case.

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(The views expressed above are personal views of the authors)

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[1] Para 2.93 and 2.94

[2] [TS-87-ITAT-2010(DEL)-TP]

[3] [TS-506-HC-2015(DEL)-TP]

[4] [TS-236-ITAT-2016(DEL)-TP]

[5] [TS-105-ITAT-2017(DEL)-TP]

[6] [TS-1011-HC-2016(DEL)-TP]

[7] [TS-488-ITAT-2016(CHNY)-TP]

[8] [TS-56-ITAT-2017(DEL)-TP]

[9] [TS-815-ITAT-2016(Bang)-TP]

[10] [TS-242-ITAT-2016(DEL)-TP]

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