The author examines a ruling by the Delhi Income Tax Tribunal in GAP India's case, in which the Indian affiliate was found not to own valuable intangible assets and thus was entitled to only a modest markup for services it provided. The case, he says, confirms the general proposition that the facts surrounding an intercompany transaction are critical in deciding which method to use to measure the reasonableness of the compensation from a related party.

In Practice

Pricing Methods

GAP's Win in India: Implications for Procurement Transfer Pricing

By J. Harold McClure, Thomson Reuters

J. Harold McClure is a member of Thomson Reuters’ OneSource transfer pricing group.

The appropriate compensation for a related-party procurement company was the issue in the recent ruling by the Delhi Income Tax Appellate Tribunal in GAP International Sourcing (India) Private Limited. The positions by the two litigants were similar to the alternative models this author posited in an earlier discussion of this issue, but with an interesting twist. While the earlier discussion assumed that the taxpayer was asserting a high commission rate, with the tax authority arguing for a much lower rate, GAP was arguing for a very low commission rate, whereas the transfer pricing officer was asserting a high commission rate. The arguments of the two litigants and the tribunal's ruling offer an opportunity to revisit this issue.

Basic Facts in GAP India
GAP Inc. is a global specialty apparel company that purchases merchandise from more than 1,000 vendors in 43 nations. GAP International Sourcing (India) Private Limited is one of its foreign sourcing affiliates. This affiliate was responsible for sourcing apparel from India by providing assistance in the identification of qualified vendors, provision of assistance in procuring apparel from these vendors, inspection and quality control, and ensuring delivery of the apparel to the GAP retailers.

The intercompany compensation provided to this Indian affiliate was based on covering its operating expenses a plus profit element equal to a 15 percent markup over these operating expenses. GAP relied upon an application of the transaction net margin method (TNMM) to evaluate the reasonableness of this transfer pricing policy.

India's TPO asserted that the intercompany compensation should equal 5 percent of the volume of goods sourced by this Indian affiliate on behalf of the GAP retailers. The table below presents a simple illustration of the differences in these two positions that captures the essence of this litigation. This table assumes that the volume of goods sourced each year equals $1.5 billion and that operating expenses represent a mere 0.6 percent of the volume of goods.

### Alternative Transfer Pricing Positions (in millions)

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer</th>
<th>Tax Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Commission</td>
<td>$10.5</td>
<td>$75</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>$9</td>
<td>$9</td>
</tr>
<tr>
<td>Operating profits</td>
<td>$1.5</td>
<td>$66</td>
</tr>
</tbody>
</table>

The table illustrates the difference between a commission rate equal to only 0.7 percent versus the 5 percent commission rate asserted by the TPO. The TPO's assertion would increase commission income by $64.5 million per year. While the 0.7 percent commission rate translates into a ratio of operating profits relative to operating expenses just over 15 percent, the 5 percent commission rate translates into a ratio of operating profits relative to operating expenses in excess of 730 percent.

### Tax Authority's Position

The Indian tax authority's position in this litigation was similar to the position taken by many taxpayers that use procurement affiliates located in low-tax jurisdictions to source goods from third-party vendors in China. The tax authority asserted that this Indian affiliate had developed valuable intangible assets, including sourcing intangibles, and was performing all the key functions related to procuring goods from low-cost vendors on behalf of the GAP retailers. The
tax authority also argued that a 5 percent commission rate was the typical compensation paid to third-party procurement companies. While the tax authority did not formally quantify the cost savings afforded to the GAP retailers by sourcing goods from Indian vendors, its arguments were similar to those presented by taxpayers when trying to justify intercompany commission rates that are often exceed 5 percent of the volume of goods sourced.

Transfer pricing reports prepared on behalf of taxpayers wishing to defend high commission rates for their procurement affiliates often rely on the commission rates received by third-party sourcing companies during a period before the opening of free trade with China. Literature on entrepot trade—which literally means brokers that earn substantial profits—cites two types of intangible assets that were owned by the entrepot traders:

- sourcing intangibles which allowed for informational rents; and
- quota rights which allowed for rents due to the presence of trade restrictions.

The opening of free trade with China likely has eliminated the rents from quota rights, but, as the author has noted previously:

The termination of the Multi-Fibre Agreement may have dissipated the value of these quota rents, as free trade lowered the price paid by the U.S. buyers of apparel but drove up the payments to the Chinese manufacturers. The simultaneous decrease in the price paid by a buyer and the increase in the price to manufacturers was possible because the commission rates paid to the Hong Kong entrepots were competed downward by the opening of free trade. *The Wall Street Journal* recently noted that Hong Kong sourcing agents make significant income by assisting buyers of Chinese products with the quota system. The *Journal* also suggested that the expiration of the Multi-Fibre Agreement would lead to lower profits for these sourcing agents unless they found a way to create more value, such as by increasing their role as general contractors or creating apparel designs. While there is no direct evidence that commission rates have declined in the apparel procurement sector, the only third-party contract offered by competitors as a CUT in this sector that was signed after the termination of the Multi-Fibre Agreement had Li & Fung receiving a commission rate of just 5%. While intangible profits from quota rents have dissipated as trade barriers have been lowered, intangible profits from sourcing intangibles should still exist. Profits beyond what would be predicted using the traditional CPM approach may be justified if the related-party procurement entity undertakes the risks that Freeman and Hanson noted for entrepots that act as general contractors. If the related-party procurement entity takes these risks and owns sourcing intangibles, the commission rates in the CUT approaches often seen in transfer pricing analyses may be justified.

In other words, the market place still may afford above routine returns for sourcing companies if the company owns sourcing intangibles. Just as this argument is at least the implicit assumption by the representatives of multinationals with procurement affiliates receiving high commission rates, the TPO in the *GAP India* litigation explicitly asserted that the procurement affiliate deserved a 5 percent commission rate because it allegedly owned valuable sourcing intangibles.
Taxpayer's Position

The taxpayer rejected this characterization of its procurement affiliate, asserting that it neither owned valuable intangible assets nor took significant economic risks. The taxpayer's characterization of this transaction asserted that GAP India was a mere service provider entitled to profits that represented a modest markup over its value-added expenses.

The transfer pricing analysis compared the ratio of operating profits to value-added expenses of comparable third-party entities to the value-added expenses of the Indian procurement affiliate. In the latter case, the only expenses of the affiliate were these value-added expenses, which implied its reported operating expenses were equivalent to value-added expenses. The Berry ratio, which had its foundation in the U.S. court case involving a limited-function distribution affiliate for E. I. DuPont de Nemours, often compares the ratio of gross profit (or commission income in the case of a broker) to operating expenses for the related party being evaluated and comparable third parties. Such comparisons, however, may be misleading if operating expenses do not fully capture all value-added expenses. In situations where a portion of the value-added expenses are reported as cost of goods sold, a reliable evaluation would reclassify such expenses before this comparison is performed. The transfer pricing analysis performed on behalf of the taxpayer was able to demonstrate that a ratio of operating profits to value-added expenses equal to a 15 percent markup was reasonable based on a range derived from third-party entities deemed comparable to the Indian procurement affiliate.

The tribunal decision commented on the implications of the TPO's contention that the commission rate should be 5 percent of the volume of goods sourced by noting that this commission rate implied a very high ratio of operating profits to value-added expenses, “which is unrealistic, impractical and absurd.” The tribunal's decision also took note of another case involving Li & Fung India where the Indian tax authority also argued for the position that the Indian procurement affiliate owned valuable intangible assets. While the Indian tax authorities won this particular litigation, the tribunal also noted that the resulting operating profit to value-added expense ratio under the tax authority's position was only slightly above 32 percent. The lower ratio of operating profits to value-added expenses in this litigation was due to two factors. The first factor, as the tribunal noted, was that the tax authority ultimately sought only a 3 percent commission rate as opposed to the 5 percent commission rate in the GAP India litigation. The other factor was due to the fact that the Li & Fung Indian affiliate had higher operating expenses relative to the volume of goods sourced than GAP's Indian affiliate.

Clark Chandler and Irving Plotkin offer the following critique of the Berry ratio:

[T]he Berry Ratio approach assumes that distributors' capital requirements vary in direct proportion to their operating expenses. While Dr. Berry makes this assumption due to the difficulty often encountered in measuring economic assets, the Berry Ratio approach is appropriate only if there is specific reason to believe that operating expenses and capital requirements are closely related. In many cases, they are not. The Berry Ratio cannot be employed (at least without adjustment) in cases where there are clear differences between operating expenses and capital requirements … As a result, the Berry ratio approach cannot be used (at least not by itself) in cases where there is reason to believe that the
capital requirements of the related distributor differ significantly from those of the unrelated firm in a way that is not linked to differences in operating expenses.

Their emphasis on capital requirements can be seen as addressing two factual questions about the related-party affiliate under inquiry and the third-party distributors used as allegedly comparable companies. The traditional question raised by transfer pricing practitioners is the relative extent of working capital required in the performance of the functions of the related-party affiliate as well as the third-party entities offered as comparables. Procurement companies and commission agents typically do not require working capital and therefore would tend to have lower returns to value-added expenses than entities that do require working capital. The other issue is whether the entity owns valuable intangible assets. The contention of the taxpayer in this litigation was that GAP India did not own valuable intangible assets, which implies that a modest return to value-added expenses was reasonable under the arm's-length standard. It is worth noting, however, that entities with valuable intangible assets would be expected to earn higher returns.

The tribunal in the GAP India litigation also noted two international precedents. The taxpayer pointed to a case before the Supreme Court of Netherlands in the case of Belgian Coordination Centre (BCC). BCC performed certain procurement functions on behalf of its Dutch parent. The Dutch Supreme Court ruled that the BCC was entitled to operating profits equal to 5 percent of its operating expenses. The tax authority pointed to the U.S. litigation involving the procurement affiliate of Tommy Hilfiger, which originally received commissions equal to 10 percent of the volume of goods sold but later agreed to lower its commission rate to 7.5 percent. The tribunal, however, noted:

The reliance on an out of court settlement between the US revenue authorities and Tommy Hilfiger has no persuasive value as it is not any judicial pronouncement on the matter. It is pertinent to note that this instance does not contain any information about the actual facts and ground realities of the case or the settlement reached, nor does it throw any light on the nature of issues under contention between the US revenue authorities and Tommy Hilfiger. Similarly nothing about nature of FAR, services and other services, has been mentioned. In the absence of this critical set of information and an objective analysis, it is not possible to use it while comparing the case for GIS India, which stands far apart on facts.

Various members of the Big Four accounting community have commented on this litigation. The author notes only the following comment from Vijay Iver of Ernst & Young:

The sticky issue basically is that the tax office believes that when you're doing these procurement functions, you are performing a critical function in the supply chain and therefore you should get a percentage of the total value of goods procured from India and it could result in absurd profitability for the Indian company, but you should still get a percentage of the global turnover arising from India. This is totally contrary to the way we would look at a transfer pricing methodology for an activity like this because procurement is usually treated as a non-core activity and therefore when you're performing a non-core activity, you should try and target profitability based on the cost levels of the operations in India.
When Iver says “we” in reference to how someone should review this transfer pricing issue, one must question whether he is referring to Ernst & Young globally, as he claims the position taken by the Indian tax authorities is contrary to the customary way of viewing this issue. U.S.-based multinationals with procurement affiliates in low-tax jurisdictions often employ practitioners at the Big Four accounting firms as well as law firms to argue for positions with commission rates that are 5 percent of the volume of goods sourced or greater. While the TNMM approach used by representatives of GAP’s Indian affiliate may be used by taxpayers in other situations, this approach is often rejected by the representatives of taxpayers when such representatives are trying to justify high commission rates.

**Conclusion**

That certain transfer pricing representatives advocate approaches to justify high commission rates in some situations versus advocating TNMM to justify modest commission rates depending on what their client wants to argue is not surprising. The arm’s-length standard, however, should be based on the particular facts surrounding the intercompany transaction and not the self-serving wishes of the client—be that client a tax authority or a taxpayer.

*GAP India* is of special interest as representatives for both the tax authority arguing for a high commission rate and the taxpayer arguing for a modest rate were particularly impressive in how they presented their competing positions. The recent release from the United Nations on transfer pricing notes that the Indian tax authorities dispute the characterization from multinational enterprises that their Indian affiliates are low-risk service providers entitled to only routine cost-plus compensation. The tax authority asserts that these entities perform core functions and offer various location savings in part because of access to products at low cost.  

Had the facts shown that the Indian affiliate owned valuable sourcing intangibles, the case made by the TPO would have been more compelling. However, the tribunal ultimately concluded that the Indian affiliate did not own valuable intangible assets and hence was entitled to only a modest markup for the provision of routine services. This litigation confirms the general proposition that the particular facts surrounding the intercompany transaction are critical for deciding what method to use evaluating the reasonableness of the intercompany compensation.

**Footnotes**


2 Its other sourcing affiliates are located in Honduras, Hong Kong, Mexico, Singapore, Thailand, and the United Arab Emirates.

3 If the dollar were the equivalent of 40 Indian rupees, the transfer pricing adjustment would represent 2.58 billion rupees per year.
4 E.I. DuPont De Nemours, 44 AFTR 2d 79-5906, 221 Ct. Cl. 333, 608 F.2d 445, 79-2 USTC.

5 “Economic Issues in Intercompany Transfer Pricing,” 2 Transfer Pricing Special Report 2, 10/20/93.
