Use of Berry Ratio to Compute Arm's Length Price

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1. Opening

You might know this. To compute Arm's Length Price, under Resale Price Method (RPM), Cost Plus Method (CPM) and Transactional Net Margin Method (TNMM), we use a Profit Level Indicator (PLI), to compare profitability of either the Taxpayer or its Associated Enterprise (the Tested Party) with that of Comparables. The PLI that we use with RPM is the ratio of 'Gross Profit (GP)/Sales'; with CPM it is 'GP/Cost'. And with TNMM the PLI is one of these three ratios: 'Operating Profit (OP)/Sales' or 'OP/Cost' or 'OP/Assets'.

But do the Indian Transfer Pricing Regulations permit us to use any other PLI - other than those mentioned above - to compute the Arm's Length Price? In *Mitsubishi Corporation India (P) Ltd vs DCIT, [2014] 50 taxmann.com 379 (Delhi - Trib),* a ruling that was harbinger of good news for Taxpayers, the Tribunal approved the use of Berry Ratio as a PLI in certain situations.

2. What is Berry Ratio?

Berry Ratio is nothing but the ratio of 'Gross Profit (GP)/Operating Cost' - the denominator is also known as *Operating Expenses* or *Value Adding Expenses* or *SG&A Expenses (Selling, General and Administration*

Expenses). That is fine. But what is the economic significance of Berry Ratio?

Economically, Berry Ratio is the measure of return on *Value Adding Functions* performed by an enterprise, where Operating Expenses are the only expenses borne by that enterprise. In such a case the entire Functions, Assets and Risks (FAR) profile is represented by, and reflecting in, the Operating Expenses - thus Operating Expenses are the real Value Adding Expenses (VAE). The Cost of Goods Sold (COGS) or the Cost of Inventory, though booked in accounts, do not add value because that Cost - and related risk - is not really borne by the enterprise, but is borne by the Associated Enterprise (AE). It is the AE who makes payment for the goods; the AE thus assumes ownership over the goods and bears the related risks. So the enterprise is not entitled to a return on the Value of Goods handled. Rather, the enterprise is entitled to a return only on the value adding functions performed by it.

To give an example, a Procurement Service Provider might book Cost of Goods Sold (COGS) and Sales in its accounts only because it takes flash title to the goods. But the Procurement Service Provider bears neither any risks nor any costs associated with the Goods. Those risks and costs are borne by the Principal (AE) to whom the Procurement Service Provider renders procurement services. The AE makes payment to suppliers, for the goods procured by the Procurement Service Provider from those suppliers, and the AE bears the inventory risk. So, no return on value of goods sourced or procured can be attributed to the Procurement Service Provider. Only the return on value adding functions performed – as reflecting in Operating Expenses – can be attributed to the Procurement Service Provider. Attributing a return on Sales or COGS to work out Arm’s Length Price in such instance would be inaccurate.

Berry Ratio can also be understood as a mark-up based solely on SG&A Expenses, or Operating Expenses, incurred by an enterprise in rendering services to its AE.

3. A Bit of History

Berry Ratio is named in the honour of Dr. Charles Berry, an economist, who served as an expert witness on behalf of the U.S. government in the landmark case of **E.I. DuPont de Nemours & Co vs United States, 608 F.2d 445.** In that case - pertaining to a Distributor - Berry utilized the ratio of 'Gross Profit/Operating Expenses' as PLI, to compare the profitability of the Taxpayer Distributor with the profitability of the comparable Distributors.

Berry's key insight was that Low Risk Distributors are basically service providers (providing distribution services to the Manufacturer) and not traders. So they should earn a return commensurate to the distribution services performed, and *the value of the products being distributed was irrelevant*. Low Risk Distributors must, therefore, achieve a particular Gross Profit in order to earn a fair compensation for their distribution services - the costs of providing those services are accounted for, almost entirely, in the operating expenses.

4. Utility of Berry Ratio

The Berry Ratio is useful for computing arm's length compensation of Limited or Low Risk Distributors or Procurement Entities (with zero inventory levels), or even Service Providers, where the concerned Entity needs to be compensated with reference to Operating Expenses. That is because, in such cases, the Operating Expenses capture the entire value addition, or the whole of the FAR – the value of goods or COGS is thus irrelevant.

Stated differently, where the Gross Profit is realized by performing functions that are fully captured by Operating Expenses, Berry Ratio is the best indicator for comparison of Tested Party's profitability with that of the comparables.

5. When should we use Berry Ratio as a PLI?

For the Berry Ratio to yield reliable arm's length results, there must exist a direct link between SG&A Expenses, or the Operating Expenses, and the Gross Profit levels. For that reason, we should use Berry Ratio only in cases of Limited Risk Distributors, Procurement Entities and Service Providers, that employ no intangible assets.

Simply put, the Berry Ratio should not be applied when intangibles exist within the business activity of either the Tested Party or the Comparables. Why? Because it becomes difficult, if not impossible, to determine the impact that the levels of SG&A Expenses, or the Operating Expenses, have on Gross Profits, when intangibles are present.

5.1 OECD TP Guidelines

As stated in the July 2010 version of OECD Transfer Pricing Guidelines, we can use Berry Ratio when the following conditions are met:

- The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses,
- The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, i.e. it is not proportional to sales, and
- The taxpayer does not perform, in the controlled transactions, any other significant function (e.g. manufacturing function) that should be remunerated using another method or financial indicator.

According to the OECD, a situation where Berry Ratio can prove useful is intermediary activities, where a taxpayer purchases goods from an Associated Enterprise and on-sells them to other Associated Enterprises. In such cases, the Resale Price Method may not be applicable given the absence of uncontrolled sales, and a Cost Plus Method that would provide for a mark-up on the cost of goods sold might not be applicable either where the Cost of Goods Sold consists in controlled purchases. By contrast, operating expenses in the case of an intermediary may be reasonably independent from Transfer Pricing formulation.

5.2 In Practice

In practice, the Berry Ratio is used for arm's length benchmarking in cases of Limited Risk Distributors, Procurement Entities and Service Providers, if no unique intangibles are employed by them.

In such cases no funds are blocked in the Inventories, or in Cost of Sales, and the Operating Expenses (or the Value Added Expenses) is all that the Taxpayer has de facto borne. Computation of return on the Value of Goods, by applying a PLI based on COGS or Sales, will therefore lead to an exorbitant return on the Operating Expenses.

For instance, if due to flash title taken to goods, the Sales booked in the accounts are 100 and Operating Expenses are 10, then arm's length remuneration, for rendering distribution services to AE, at 5% of Sales (5% of 100=5) will be much higher than the remuneration of 15% of Operating Expenses (15% of 10 = 1.5). And remuneration at 15% of *Total Cost*, including COGS, too will be dis-proportionately high. Also note the exorbitant return of 50% (5/10) on Operating Expenses, when 5% of Sales is applied to compute the arm's length remuneration.

6. Tribunal has approved the use of Berry Ratio in Mitsubishi Corporation India (P) Ltd vs DCIT, [2014] 50 taxmann.com 379 (Delhi - Trib)

This was a case pertaining to an Indian Procurement Entity (IPE) of a Japanese Giant Trading Company (i.e. Sogo Shosha, the Japanese term for Giant Trading Companies). An IPE is typically the procurement arm of a Global Trading Company. As an integral part of the Global Trading Group, the IPE assists and supports the Group in procuring goods from India.

The Tribunal has ruled that the Cost of Goods Sold (COGS), or Cost of Inventories, though booked in accounts, is not relevant to benchmarking in case of an IPE, because the COGS is not borne by the IPE but is borne by the AE. Hence, the entire FAR of IPE is captured by the Operating Expenses. The value addition made by the IPE – in course of carrying out its procurement functions – is fully reflected in the Operating Expenses alone. As a matter of fact, the Operating Expenses represent all of the expenses borne by IPE.

COGS is a measure of *return on value of goods traded, sourced or handled*; it is not a measure of *return on the value adding functions* (trading support functions) performed by the IPE. And so - even though IPE takes flash title to goods and books COGS and related Sales in its accounts - COGS and Sales are not relevant to benchmarking.

That being the case, the return on the value of procurement functions performed – as reflected in Operating Expenses – alone needs to be considered, while undertaking the comparability analysis. And the return on value of goods procured needs to be ignored. How to accomplish that? Answer: by use of Berry Ratio as PLI.

7. Is the use of Berry Ratio permitted under the Indian TP Regulations?

Revenue Authorities argue that the use of Berry Ratio is not permitted by the Indian TP Regulations. On this point the relevant provision is Rule 10B(1)(e)(i) of the Income Tax Rules, 1962. That Rule prescribes the PLIs to use while applying TNMM to determine the Arm's Length Price.

After carefully considering Rule 10B(1)(e)(i), the Tribunal, in *Mitsubishi Case (supra),* has pointed out that we can use Berry Ratio under the Indian TP Regulations. Below are the Tribunal's observations in that case:

- The basis of computation of PLI, as set out in Rule 10B(1)(e)(i), is only illustrative - it is not exhaustive.

- It is notable that Rule 10B(1)(e)(i) ends with the expression "or having regard to any other relevant base".
- A cost base does not cease to be permissible under Rule 10B(1)(e)(i) just because that cost base is not comprised of Costs incurred, Sales effected or Assets employed.
- When Cost of Inventory is excluded from the cost base, for the reason that no resources are used in the inventories, for all practical purposes the cost-base consists only of the operational costs.
- And such cost base fits within the overall scheme of Rule 10B(1)(e)(i).

Based on the above observations the Tribunal ruled that we can use Berry Ratio as a PLI with TNMM.

8. Closing Remarks

In addition to the regular PLIs of 'GP/Sales' (with RPM), 'GP/Cost' (with CPM), and 'OP/Sales or Cost or Assets' (with TNMM) we may also consider Berry Ratio (GP/Operating Cost) to compute Arm's Length Price in appropriate cases. The cases where use of Berry Ratio would be appropriate are the cases of Limited Risk Distributors, Procurement Entities and Service Providers, if no unique intangibles are employed by them.

In such cases the COGS or Sales, though booked in accounts, is not relevant to arm's length benchmarking because the cost of goods and related inventory risks are not borne by the Taxpayer but are borne by the Associated Enterprise. In fact, the operating costs alone are borne by the Taxpayer. So in such cases the operating costs capture all the value adding functions performed by the Taxpayer, in course of rendering distribution services or procurement services or other services to its Associated Enterprise. Hence, a PLI based on COGS or Sales will not yield a reliable measure of Arm's Length Price. Instead, a PLI based on Operating Cost or Value Adding Expenses, such as Berry Ratio, would be reliable.

In *Mitsubishi Corporation India (P) Ltd vs DCIT, [2014] 50 taxmann.com 379 (Delhi - Trib),* the Tribunal approved the use of Berry Ratio to work out Arm's Length Price in cases of Indian Procurement Entities of Global Trading Groups. There the Tribunal also ruled that Berry Ratio is a permissible PLI under the Indian TP Regulations.

A final point: one should, however, not follow this ruling blindly; it still is critical to determine the FAR profile of the Taxpayer and its AE to arrive at an appropriate PLI to determine the arm's length price.

Thank You.

Hope you found this Article worthy of your precious time.

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