Appropriate Application of the Berry Ratio as a Profit Level Indicator

The author discusses the appropriate application of the Berry ratio as a profit level inductor. Guidance from the OECD, the United States, and Japan is considered, along with case law from Indian courts.

1. Introduction

In the course of globalization, the role of multinational companies in world trade has grown radically over the last couple of decades. As a consequence, the amount of cross-border related-party transactions has increased many times over.

The transfer price charged amongst related parties for a transaction is relevant for both taxpayers and tax authorities, as the transfer price could be tainted by the motive to shift profit from a high-tax jurisdiction to a low-tax jurisdiction. Therefore, it is important for a taxpayer to demonstrate to the tax authorities that its transfer prices adhere to the arm's length principle. In determining the arm's length price, various profit level indicators could be resorted to, such as gross profit, operating profit, return on assets or the Berry ratio. Selection of an inappropriate profit level indicator will not only taint the entire analysis but will also deceive the taxpayer into believing that its related-party transactions are at arms length. Therefore, the selection of an appropriate profit level indicator is crucial in the entire process of carrying out the economic analysis.

The Berry ratio is one of the leading indicators of a company's profitability, and is used to make determinations about transfer pricing for various corporations and businesses. The Berry ratio is determined by dividing the gross profit by operating expenses of the company, and compared with the results of companies in a similar industry.

The Berry ratio is one of the few profit level indicators which should be applied selectively, bearing in mind the nature of the functions performed by the tested party. Misapplication of the Berry ratio could lead to absolutely absurd results. The Berry ratio has been accepted in the United States since the 1990s and was introduced into the OECD Guidelines in July 2010.

This article discusses in detail the appropriate application of the Berry ratio as a profit level inductor.

2. Evolution of the Berry Ratio

The Berry ratio was first introduced by Dr Charles Berry in the US transfer pricing case of E.I. DuPont de Nemours and Co. v. United States. DuPont, then the largest chemical company in the world, established a wholly owned subsidiary in Switzerland, as a general marketing presence in Europe for the DuPont family of corporations. The sole purpose of the Swiss subsidiary was to represent DuPont at trade fairs in the European region, and to provide marketing support services. In addition to these activities, commercial sales were also routed through the Swiss subsidiary, which in turn acted as a “super-distributor” on behalf of the parent. It was remunerated through a margin averaging to 20%.

The US Internal Revenue Services (IRS) took the position that, in light of the functions performed, the Swiss subsidiary was excessively remunerated. It was determined that the subsidiary did not act as a “typical distributor”, as it did not perform logistics and accounting services, and in some cases did take physical possession of the products sold.

In order to justify the excessive remuneration of the Swiss subsidiary, it was raised before the Court that the gross profit divided by operating expenses should be compared with independent comparable companies performing similar functions. Absurd results were obtained and it was thus concluded that the remuneration of the Swiss subsidiary was significantly above the arm’s length remuneration.

In the DuPont case, while the subsidiary’s resale margin was well within the range of gross margins of independent comparable companies in similar industry, it was well noted that the operating margins were very high. The Court thus held that the lower level of operating expense was attributable to a lower level of risk borne in comparison to independent companies in a similar industry.

The Berry ratio is the ratio of a company’s gross profit to operating expenses. It must be used with abundant caution, as the Berry ratio assigns a markup solely on selling, general and administration (SG&A) expense instead of to total cost.

From a practical application perspective, a Berry ratio should be applied only to examine the profitability of limited risk distributors or pure service providers that utilize no intangible assets when performing their day-to-day operations. The tested party must accomplish a result of one in order to demonstrate a profit; a score of less than one indicate that the company is operating at a...
loss. Higher numerical results are preferable, while lower results typically indicate a company in financial difficulty.

The theory of the Berry ratio is very relevant in today’s times when various merchants operate as limited risk-bearing distributors and have limited functions to perform. In addition to limited risk distributors, the Berry ratio is also relevant for raw material resellers and intermediary distributors that do not add value in the supply chain in terms of marketing efforts of after-sales support. The sole function performed by them is resale of goods purchased.

Considering that the gross profit is equal to the difference between operating expense and operating profit, the Berry ratio is equal to sum of operating expense and operating profit, divided by operating expenses, which is equal to 1 plus ratio of operating profit by operating expenses. Therefore, if the company has positive profits, the Berry ratio has to be greater than one. For example if the Berry ratio for a taxpayer is 130%, the resultant ratio of operating profit / operating expenses would automatically be 30%.

### 3. Applicability of the Berry Ratio

#### 3.1. Distributors

Generally for companies engaged in distribution functions, most or all of their cost of goods sold (COGS) is a pass-through. This implies that, for such distributors, the entire COGS represents the arm’s length value of the direct labour and capital employed by third-party suppliers to produce the goods that the distributor has purchased. In contrast, operating expenses represent the “value added cost”. This implies that operating expenses indicate the actual value that the distributor has added in the entire supply chain.

In order to determine the market price for any goods and services as a reward for the capital employed and labour undertaken, rather than that of its suppliers, the focus is on operating expenses (value added costs). Therefore, the numerator of the Berry ratio (i.e. gross profit) is the portion of the distributor’s revenue that rewards the distributor for its value added function, while the denominator (i.e. operating expense) is the value added.

#### 3.2. Functional analysis

A detailed functional analysis is necessary before adopting the Berry ratio as a profit level indicator, as in practice the Berry ratio reflects the low risk profile of a pure distribution function, as compared to that of other independent distributors. The Berry ratio cannot be applied to an integrated distributor that performs different functions such as assembling or customizing, because the ratio will not be able to reflect the pure return on operating expenses.

Furthermore, the Berry ratio may not be appropriate for manufacturing activities, as it is often difficult to distinguish which expenses relate to which activities and in what proportions. A manufacturer’s cost base typically comprises not only operating expenses but also the cost of goods sold. In this regard, a profitability measure based solely on reduced operating expenses does not seem to be the most reliable one. For manufacturing activities, in addition to a markup on costs, a check of the return on assets should also be performed.

#### 3.3. Economic analysis

Conducting a thorough qualitative and quantitative search is crucial in order to arrive at a robust set of comparable companies performing the same functions as the tested party, and this is critical for the application of the Berry ratio. A set of inappropriate comparable companies will depict wrong level of profitability out to be attributed to the tested party for the functions performed.

A high degree of similarity is required in the comparables selected, as the Berry ratio computes the level of profitability by marking up value added expenses. Selecting comparables in different industries where the impact of value added expense activity on profits, may vary will yield different profit levels than those of the tested party’s industry.

For example clear comparability issues would arise if pharmaceutical marketing comparables were used when considering an arm’s length markup for commodity-based distributors. Failure to locate comparables that perform functions of similar value, while facing similar business pressures, could result in a distorted profit level being attributed to the tested party.

#### 3.4. Intangibles

As mentioned, in order to apply Berry ratio correctly, a direct link must exist between value added expense and gross profit. In order to identify an appropriate set of comparables to compare the profitability of the tested party, there is a need to find comparables that have little in the way of intangible assets.

Therefore, the Berry ratio should not be applied when there are intangibles within the commercial activity of either the tested party or the comparable companies. In practice, it is difficult to regulate the scope of the impact that value added expense levels have on gross profit when intangibles are present. Applying the Berry ratio requires the tested party to be limited to a stripped distributor or a pure service provider that possesses little in the way of intangible assets.

Given the significance that intangibles are assuming in generating value, the Berry ratio is less likely to provide arm’s length profit levels and thus should be applied only in exceptional cases.

#### 3.5. Geographic similarity

Special care should be taken when comparing the Berry ratios of companies from different countries, as – due to the cost accounting standards – the cost bases may be not comparable. As a result, the application of the Berry ratio when setting transfer prices will result in non-arm’s length prices. From example if a company’s gross profit is EUR 12 million, operating expenses are EUR 8 million and operating profit is EUR 4 million, the Berry ratio is 1.5. However, if the company attributes EUR 4 million costs to cost of
goods sold but not to operating expenses, the Berry ratio would increase from 1.5 to 2 (in this situation, the gross profit would be EUR 8 million, operating expenses would be 4 and operating profit would be 4).

3.6. Capital intensity

The Berry ratio increases with an increase in capital intensity, at a rate equal to return on capital employed (ROCE). The key implication is that a Berry ratio comparison of firms with different asset intensities (i.e. different CE/OpX ratios) will be extremely misleading. And, similar to the conclusion above, the application of a comparable company’s Berry ratio to a tested party with an asset intensity that is materially different from the comparable, will lead to a non-arms length result (over or under compensation of the distributor).

A distributor buys for the purposes of reselling those products at a profit. The distributor must realize a gross margin sufficient to cover both (i) operating expenses and (ii) the cost of obtaining debt and equity capital required to operate a distribution business. As for the second component of the gross margin, the return needed to cover capital costs, the Berry ratio assumes that distributors’ capital requirements vary in direct proportion to their operating expenses.

The Berry ratio cannot be employed, at least not without significant adjustment, in cases where there are clear differences between operating expenses and capital requirements. In more precise language, if the CE/OpX ratios differ as between the comparables and the tested party, or across the comparables, the Berry ratio will be an inherently unreliable profit level indicator.

4. International Guidance

4.1. OECD Guidelines

The OECD supports the use of the Berry ratio, and has clearly defined it as the ratio of gross profit to operating expenses. Interest and extraneous income are generally excluded from the gross profit determination; depreciation and amortization may or may not be included in operating expenses. The OECD has also provided certain criteria which need to be met in order to apply the Berry ratio as an appropriate profit level indicator.

The OECD Transfer Pricing Guidelines (OECD Guidelines) also state that a situation where the Berry ratio can be a best fit is for intermediary functions that involve buy and sell transactions without much value addition. In such cases, the resale price method may not be applicable, given the absence of uncontrolled sales, and the cost-plus method that would provide for a markup on the cost of goods sold might not be applicable either where the cost of goods sold consists of controlled purchases. By contrast, operating expenses in the case of an intermediary may be reasonably independent from transfer pricing considerations, unless they are materially affected by related-party costs such as head office charges, rental fees and royalties paid to a related party, so that a Berry ratio may be an appropriate indicator, subject to the comments above.

However, according to the OECD Guidelines, one of the common complications in the determination of the Berry ratio, is that the Berry ratio is very sensitive to the classification of costs as operating expenses or not, and therefore can give rise to comparability issues.

4.2. UN Manual

In the manual issued by the United Nation on transfer pricing (UN Manual), the Berry ratio has been accepted as an appropriate profit level indicator for determining the return for services performed by a distributor. The UN Manual has preconditioned that application of the Berry ratio to certain elements, such as functions performed, assets used and risk assumed.

It has been stated that the Berry ratio assumes that there is a relationship between the level of operating expenses and the level of gross profit earned by a distributor or service provider, in the situation where the value added functions are clearly reflected in the operating expense.

Having said the above, UN Manual also emphasizes the limitations of the Berry ratio as an appropriate profit level indicator. In stating this, it is also suggested that use of multiple profit level indicators tends to aid additional assurance that the results are reliable.

4.3. US transfer pricing regulations

In the United States, transfer pricing regulations clearly state that the Berry ratio may be adopted as an appropriate profit level indicator, as it is widely accepted. The regulations acknowledge that the Berry ratio represents a return for services performed by a distributor. The UN Manual has accepted the Berry ratio as an appropriate profit level indicator for determining the return for services performed by a distributor.

The regulations further clarify that the Berry ratio should be adopted with ample caution, as inappropriate application could result in distorted results. It is further clarified that the gross profit margin has not been favoured as a profit level indicator because the categorization of expenses as operating expenses or cost of goods sold may be subject to manipulation, so that a taxpayer generating significant operating losses could nevertheless show gross margins within an arm’s length range defined by a set of comparables with high operating profit.

4.4. Japanese transfer pricing rules

As an outcome of tax law reform implemented in March 2013 and effective from 1 April 2013, Japanese transfer pricing rules have included the Berry ratio, which may be


3. UN Manual, supra n. 2, paras. 6.3.7.1 and 6.3.7.3.
4. UN Manual, supra n. 2, para. 6.3.7.3.
5. See https://www.irs.gov/irm/part4/irm_04-061-003.html (para. 4.61.3.4.1).
6. See https://www.irs.gov/pub/irs-apo/apa_study_guide_pdf (Regs 1.482-5(b)(4)).
7. Supra n. 6.
applied to all companies, if appropriate, to determine the arm’s length price.\textsuperscript{8} Under these rules, application of the Berry ratio is permitted if:

1. the Japanese entity is operating either as a limited risk distributor or as a service provider; and
2. the most appropriate method selected to evaluate the intercompany transaction is the transactional net margin method (TNMM).

It is anticipated that the introduction of the Berry ratio will prove to be favourable for those companies operating as distributors or service providers, with regard to transactions with their Japanese affiliates. The adoption of the Berry ratio by Japanese transfer pricing rules aligns them with the OECD Guidelines and global best practices.

5. Berry Ratio in India: Supporting Case Law

5.1. Sumitomo Corporation India case

In the Sumitomo Corporation India case, the Delhi High Court laid down certain notable clarifications regarding the concept of the Berry ratio from a transfer pricing perspective.\textsuperscript{9} As a background of the case, the taxpayer was an Indian subsidiary of Sumitomo Corporation Japan, which is one of the largest trading companies globally. The taxpayer (Sumitomo India) was involved in both (i) a trading function through buying and selling of products and (ii) “indenting” functions through performing agency services.

In the transfer pricing documentation, in order to determine the arm’s length price, the Berry ratio was applied under the TNMM to benchmark the combined results from trading as well as the indenting functions. It was stated that combined results were tested, as there was no difference in the functions performed under both the business units. Therefore, the entity was not undertaking any additional risks with reference to inventory or debtors as part of the trading business.

The tax authorities rejected the use of the Berry ratio on several grounds. First, they asserted that the use of the Berry ratio is not a prescribed profit level indicator within the scheme of the TNMM under Indian transfer pricing rules. The tax authorities made a transfer pricing adjustment for the indenting function by taking the gross profit relating to the trading business carried out by Sumitomo India with its overseas associated enterprises.

Further, the Delhi High Court laid down criteria for applying the Berry ratio, including in cases where (i) the price of goods has no relevance to the quantum of profits and (ii) the profits are mainly dependent on operating expenses (i.e. in cases of limited risk distributors that do not contribute to significant intangibles and also do not carry out inventory or debtor-related functions). Therefore, a distributor taking flash title to goods as part of buy-sell activities should be remunerated for the amount of operating expenses incurred by it and not with respect to the price of goods, as the manufacturer of the goods would typically perform the functions and bear the associated risks with respect to the inventory and debtors.

Having stated the above, the High Court accepted the contentions of the tax authorities that the Berry ratio could not be applied to the indenting business of the taxpayer. According to Sumitomo India, it applied the Berry ratio to test the profitability of the combined segments of trading and indenting businesses because the functional profiles of both of these segments were the same. i.e. Sumitomo India was not bearing any additional risks with reference to inventory and debtors as part of the trading business.

On appeal, the Tribunal held that because Sumitomo India performed additional functions and accordingly assumed higher risks in its trading business, the functional profiles of the trading and indenting businesses could not be the same for a proper comparison. The Tribunal proceeded to apply the commission rate earned by Sumitomo India on sales relating to the indenting business carried out by Sumitomo India with third parties, as the arm’s length price for the commission for the indenting business carried out by Sumitomo India with its overseas associated enterprises, under the comparable uncontrolled price (CUP) method.

Aggrieved, Sumitomo India appealed the matter before the Delhi High Court. In its decision, the Court first stated that the Berry ratio had legal sanctity under TNMM, as embodied in the Indian transfer pricing rules. In fact, the ITAT had also applied this PLI in a number of cases, including Cheil Communications,\textsuperscript{11} GAP International\textsuperscript{12} and Mitsubishi.\textsuperscript{13}

\textsuperscript{8} By incorporation into the Order for Enforcement of the Act on Special Measures Concerning Taxation arts. 39-12 and 39-112.
\textsuperscript{9} IN: HC Delhi, 5 May 2015, Sumitomo Corporation India Pvt. Ltd. v. CIT, ITA 83/2015, Tax Treaty Case Law IBFD.
\textsuperscript{11} IN: ITAT Delhi, 30 Nov. 2010, Cheil Communications India Pvt. Ltd. v DCTT, IA 712/DEL/2010, Tax Treaty Case Law IBFD.
\textsuperscript{12} IN: ITAT Delhi, 18 Sept. 2012, GAP International Sourcing (India) Pvt Ltd v. ACIT, ITA 5147/Del/2011 and 228/Del/2012, Tax Treaty Case Law IBFD.
\textsuperscript{13} IN: ITAT Delhi, 21 Oct. 2014, Mitsubishi Corporation India Pvt. Ltd v DCTT, ITA 5042/Del/11, Tax Treaty Case Law IBFD.
Next, the High Court clearly explained as to when such PLI should be applied, namely in cases where (i) the price of goods has no relevance to the quantum of profits and (ii) the profits are mainly dependent on the operating expenses – in other words, in cases of stripped risk or limited risk distributors that do not contribute to significant intangibles and also ideally do not carry out inventory or debtor-related functions, despite taking flash title of the goods as part of the buy-sell activities. In such situations, the distributor should ideally be seeking to obtain a mere reward for the amount of operating expenses incurred by it and not with respect to the price of goods, as the manufacturer of the goods would typically perform the functions and bear the associated risks with respect to the goods and debtors.

Having explained the concept of the Berry ratio, the High Court accepted the contentions of the tax authorities that the Berry ratio could not be applied to the indenting business of Sumitomo India, as the commission received from the principals (i.e. both associated enterprises and third parties) were linked to the value of goods dealt with by Sumitomo India, and not determined as a markup of operating expenses.

The High Court also held that the approach of the Tribunal in applying the commission earned by Sumitomo India from third parties as the arm’s length price for the commission relating to the indenting business carried out by Sumitomo India with its overseas associated enterprises, under the CUP method, was not correct. The High Court noted that no attempt had been made by the Tribunal to verify whether there were material differences in major factors (e.g. nature and volume of products) between the indenting businesses carried out with associated enterprises and third parties, which might have required adjustments to be made, before proceeding with such comparability analysis under the CUP method. With these comments, the High Court set aside the matter for fresh adjudication before the Tribunal.

At this juncture, one is tempted to consider a few significant aspects that are relevant to the present discussion.

The High Court had held that the Berry ratio, as a PLI, has limited applicability, particularly for stripped risk distributors – and also, impliedly, for agents, as they do not bear risks. Does this mean that the Berry ratio may never be applied to a normal risk-bearing distributor or agent?

Although the High Court was not required to comment upon this question, it is submitted by the author that for such risk-bearing entities, the Berry ratio may be applied as a so-called sanity check, to ensure that even such risk-bearing entities (the remuneration models for which are linked to the value of goods) have not earned exorbitant profits with reference to their operating expenses; but not as a primary method in transfer pricing.

For example assume that a normal risk-bearing distributor is awarded a return of sales of 7%; or an agent with relatively high functional profile is awarded a commission of 5% on sales, which results in a Berry ratio of 400% (i.e. an operating profit/OE of 300%). In such case doubts may arise as to the price setting mechanism itself, as the taxpayer likely would have earned a much greater reward as compared to the intensity of functions performed by it, unless one can establish that the taxpayer contributes non-routine or unique intangibles that are not found to exist in comparable companies. In the latter case, the applicability of a ‘one-sided’ method itself might come under question.

The next point concerns how one effectively sets or tests the commission received by a normal selling agent, as a percentage of sales, without resorting to the Berry ratio. While the CUP method would be the best method, the application of that method requires an extremely high degree of comparability between the tested and comparable transactions.

It can be well conceived that the rate of commission is a function of the overall activities of the agent, namely it is strongly correlated to the intensity of functions of the agent. When applying the CUP method in the case of commissions, similarity of products is of paramount importance, as such similarity evens out possible variations in the intensity of functions of the tested party and comparable companies. However, one cannot altogether eliminate doubt regarding a mismatch in intensity of functions, which would not be possible to examine in a CUP study of commission rates from third-party agency agreements, as the financials of such third parties for their agency businesses would seldom be available.

If no such robust data are available for a CUP study, nor for a proper corroboration of the data under a CUP study, taxpayers and tax authorities should endeavour to resort to advanced economics and statistical tools in order to arrive at the proper arm’s length value of the commission. The gross profit of a distributor is equivalent to the commission rate for an agent, subject to several adjustments with reference to investment in, and functions with respect to, inventory and debtors.

It is empirically proven that there is a strong correlation between gross profit and intensity of functions, which is a measure of operating expense/sales. By (i) selecting distribution companies that have more or less similar intensity of functions as the taxpayer agent, where for the taxpayer agent, sales would represent the volume of sales effected on behalf of the principal, and thereafter (ii) selecting fillers and adopting working capital adjustments to eliminate functions and risks around debtors and inventory for the comparable distributors, one may be able to obtain an adjusted gross profit that could provide a reasonable arm’s length commission rate for agency functions. If the intensity of functions of comparable distributors is much higher than the intensity of functions of the taxpayer agent (which is quite likely), one might need to apply a regression analysis to arrive at a reasonably accurate gross profit, commensurate to the intensity of functions of the taxpayer agent.

The method, as stated here, is tried and tested.
5.2. Mitsubishi Corporation case

In the Mitsubishi Corporation India case\(^{14}\) the Delhi Tribunal held that the Berry ratio is an appropriate profit level indicator for buy-sell intermediary companies, observing that activities in the nature of commissionaires cannot be recharacterized as trading activities. The taxpayer was a subsidiary of Mitsubishi Corporation Japan, one of the leading general trading companies.

Services provided to related parties by the taxpayer included facilitating communication between buyer and seller; arranging freight, insurance and customs clearance through third parties; collecting market information; identifying potential customers (in import transactions only) or suppliers (in export transactions only); and advising an associated enterprise or third party as regards regulatory or financial matters.

To justify the arms length price, the taxpayer relied upon the TNMM and considered the Berry ratio as the profit level indicator. In transfer pricing documentation, the tested party’s Berry ratio was reported as 1.19 against the Berry ratio of comparable companies of 1.14 (and adjusted Berry ratio of 1.13).\(^{15}\) As such, the taxpayer’s pricing was in line with the arms length principle. While the tax authorities rejected application of the Berry ratio because all of the international transactions relating to sales and service of commodities were not included in the PLI, and that, most notably, the cost of sales is not included in the denominator of the PLI used.\(^ {16} \)

The Tribunal held that the taxpayer performs only a small role in connecting buyers with sellers, in the form of service activity or trader activity.\(^ {17} \) The critical importance of the taxpayer in the entire supply chain lies in the lower trading margin of the sogo shosha\(^ {18} \) trading, and in relatively lesser importance of the trading activity in the overall scheme of a complex interdependent set of sogo shosha business activities. Ultimately, it is the level of inventory which is a key factor in determining the kind of trading activity that the taxpayer has been engaged in.

The Tribunal also touched upon the concept of locational savings and held that in the procurement of goods, if there are any location savings, such savings will arise to the party actually buying the goods (i.e. the related party) and not the party assisting such buying (i.e. the taxpayer, by way of acting as an intermediary).\(^ {19} \)

The Tribunal held that the taxpayer undertook back-to-back transactions, without any value addition to inventory and without any functions performed on the inventory; and is, in that sense, without any risks associated with inventory.\(^ {20} \) Thus, if the cost of inventory is included in the cost base of the taxpayer, it may not be justified on economic principles, even as this cost of sales may have to be entered on books of accounts in compliance to the accounting principles and accounting standards.

Therefore, it was concluded that the Berry ratio can be particularly useful in situations where the entity is engaged in business as a trade intermediary; the value of services performed by the entity is adequately reflected by operating expenses; the value of functions performed and assets employed in the controlled transactions is not proportionate to sales; and when the entity does not perform any significant operations such as manufacturing or processing.\(^ {21} \)

Based on the facts of this case, the taxpayer did not perform any functions on or with respect to the goods traded by it, beyond holding flash title for the goods in some instances, nor did the taxpayer bear any significant risks associated with the goods so traded.\(^ {22} \) As the taxpayer did not assume any significant risks associated with the goods traded nor perform any functions on the same, and all the risks assumed by the taxpayer are adequately reflected by operating expenses, the Berry ratio is relevant.

Regarding the recharacterization of commission activity into trading activity, the Tribunal noted that it is not permitted for the tax authorities to reconstruct the financial statements of the taxpayer by including the cost of products incurred by the associated enterprises, in respect of which services are rendered, in its reconstructed financial statements, and then subjecting the hypothetical trading profits determined in these reconstructed financial statements, to the tests for determining arms length price. The Tribunal thus rejected recharacterization.

Therefore, in arriving at its conclusion, the Tribunal gave more weight to economic principles over accounting principles in the arms length price computation. Considering the transfer prices need to be determined based on facts and circumstance on a case-to-case basis, economic principles certainly should be borne in mind. This case is a classic example of determining the arms length price.

6. Conclusion

It is clear that the Berry ratio is an appropriate indicator of profitability if adopted and applied correctly. Also, the Berry ratio is definitely an accepted profit level indicator internationally, as it has been discussed in various guidance, transfer pricing rules and supreme court rulings. Preferably, the Berry ratio should be reserved for those cases involving limited risk distributors or service providers that employ no intangible assets. For the Berry ratio to be applied, there must be a direct link between value added expense and gross profit levels.

The advantages of using the Berry ratio include the ease of administration and the lack of concern for the size of the distributors used as comparables. Its use is appropriate when the distribution activity in question consists of a limited range of functions.

14. Mitsubishi Corporation India, supra n. 15.
15. Mitsubishi Corporation India, supra n. 15, para. 4.
17. Mitsubishi Corporation India, supra n. 15, para. 27.
18. A Japanese term that is widely equated to ‘general trading’.
19. Mitsubishi Corporation India, supra n. 15, para. 70.
20. Mitsubishi Corporation India, supra n. 15, paras. 34-35.
21. Mitsubishi Corporation India, supra n. 15, para. 47.
22. Mitsubishi Corporation India, supra n. 15, para. 53.
and risks, and may be properly characterized as the provision of a service to the manufacturer. In contrast, distributors that operate with a higher degree of independence, that may own intangible assets, or which conduct value added activities in addition to mere resale of tangible goods, may be better evaluated by use of return on sales. As in all matters relating to the choice of an appropriate PLI, a comprehensive functional analysis is essential in making these distinctions in functionality, levels of risk-taking and assets employed, and insuring that a valid comparison is made with third-party comparables that exhibit similar characteristics.

Although the OECD Guidelines now makes reference to the use of the Berry ratio as a PLI, the Guidelines also identify specific criteria that are to be met in order for the Berry ratio to be considered appropriate.

Careful analysis is required in order to apply the Berry ratio, as its misapplication as a profit level indicator would mislead a company into assuming that it is transacting at arm’s length, while in actuality they may be falling well short of complying with the arm’s length standard. It is imperative that taxpayers carefully evaluate the type of entities chosen as comparables to determine whether the PLI being used may be distorted by issues such as operating expense intensity, asset intensity or account classification issues. In this context, it is also advisable to bear in mind that whenever possible, taxpayers should use more than one PLI to corroborate their transfer pricing analyses, especially if doing so will strengthen the results of the primary analyses.

In practice, gross profit margin is not a favoured profit level indicator, as the characterization of expense into operating expense and cost of goods sold may be influenced, in order to depict a favourable result in line with the arm’s length principle. Also, as different entities have different functional profiles, differences in functions performed will not be captured appropriately in the gross profit margin.