Concept of Pass-Through Costs and Their Treatment

The author analyses the concept of pass-through costs based on guidance from the OECD Transfer Pricing Guidelines, the UN Transfer Pricing Manual and transfer pricing rulings. Furthermore, this article contains a discussion on the treatment of pass-through costs from a transfer pricing perspective.

1. Introduction

Among all the transfer pricing methods, the transactional net margin method (TNMM) is the most commonly used to determine the arm’s length price of intercompany transactions. The TNMM examines the net profit relative to an appropriate base, such as cost, sales, assets and so on. It therefore requires the selection of an appropriate net profit indicator (NPI). Where an NPI that is based on cost is considered appropriate, the question can arise what should be included in the cost. Based on the facts of each case, there can be certain costs that can be categorized as “pass-through costs” to which no profit element is attributed (i.e. costs that are potentially excludable from the denominator of the NPI).

This article explains the concept of such pass-through costs by taking guidance from the OECD Transfer Pricing Guidelines (OECD TP Guidelines), the UN Transfer Pricing Manual (UN TP Manual) and transfer pricing rulings. Furthermore, the transfer pricing treatment of pass-through costs is also discussed.

2. Concept of Pass-Through Costs

According to fundamental economic principles, pass-through costs can be understood as an item of cost in respect of which the taxpayer neither performs any significant functions nor assumes any risks.

The UN TP Manual explains the concept of pass-through costs by presenting a situation wherein a multinational enterprise may decide to outsource some services to an independent entity and use an associated enterprise to act as an agent for the group to pay the accounts and then to allocate the charges to its associated enterprises on an objective basis. In such cases, the cost of outsourced services may be called pass-through costs.

The concept of pass-through costs is also discussed in some transfer pricing rulings in India. Although these rulings do not specifically define the concept of pass-through cost, inference can be drawn from the key principles emanating from these rulings. These rulings are discussed in the following paragraphs.

FedEx Express Transportation and Supply Chain Services India Private Limited

The Income Tax Appellate Tribunal (ITAT) observed that FedEx Express Transportation and Supply Chain Services India Private Limited (the taxpayer) coordinated with a third party on behalf of associated enterprises for services in connection with the custom clearance of high-value package services and routed these payments through a balance sheet. The ITAT concluded that the taxpayer was merely providing coordination services, had not incurred any direct costs nor performed any direct functions, deployed any assets or undertaken any risks in respect of custom clearance services. Thus, the payment made by the taxpayer to the third party was for and on behalf of the associated enterprise and the reimbursement by the associated enterprise was merely a pass-through cost, as no element of service was performed by the taxpayer.

Johnson Matthey India Private Limited

In this case, having considered the facts of the case and the ITAT’s findings, the Delhi High Court held that the raw material costs were a pass-through cost, as raw material was purchased by Johnson Matthey India Private Limited (the taxpayer) at the customer’s instruction, at a price negotiated by the customer and the taxpayer neither performed any function, nor assumed any risk or employed its own asset. Thus, the taxpayer’s profit was not at all affected by the cost of the raw material. Hence, the High Court upheld that it should be treated as a pass-through cost and should be excluded from the cost base of the taxpayer for computing NPI.

McDonalds India (P) Ltd

McDonalds India (P) Ltd (the taxpayer) was collecting royalty and franchise service fees from a joint venture partner based on the sublicensing agreement and remitting it to its associated enterprise as per the master licence agreement. The ITAT observed that there was no value

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addition to the collection of royalty and franchise fees amount and reimbursement to the associated enterprise and furthermore that the taxpayer had not commercially exploited the royalty/franchise fees as it was required to remit such funds within 5 days of the end of each month. Given this, the ITAT opined that the fees constituted a pass-through cost.

Ericsson India Pvt Ltd

Ericsson India Pvt Ltd (the taxpayer) recovered the cost relating to ancillary and non-core hardware supplied to an associated enterprise. The tax authority added markup on such recoveries. The Delhi ITAT observed that the taxpayer only acted as a facilitator for its associated enterprise and did not undertake any transaction on a regular basis. The main purpose of undertaking such a transaction was to achieve administrative convenience for the associated enterprise. The ITAT held that the transaction of cost recovery for supply of hardware was a mere pass-through cost that was timely reimbursed to the taxpayer by the associated enterprise. Thus, such a pass-through cost could not entail a markup since no service was being rendered by the taxpayer.

To summarize, for a cost to be treated as a pass-through cost, the taxpayer has to demonstrate that there were no functions performed or risks assumed relating to these costs and that it was merely acting as a facilitator. Thus, a detailed functional analysis should be undertaken and appropriately documented by the taxpayer to demonstrate the pass-through nature of costs. If the taxpayer has incurred the cost as a principal/entrepreneur on its own account, the treatment of such costs as pass-through costs may not be acceptable.

3. Transfer Pricing Treatment of Pass-Through Costs

Once it has been established that a certain portion of the taxpayer’s costs are pass-through costs, the next aspect is to analyse to what extent it is acceptable arm’s length practice that no markup or margin is earned by the taxpayer on such pass-through costs. This depends on the extent to which an independent party in comparable circumstances would agree not to earn a markup or margin on such costs, i.e. it depends on a comparability analysis.

In cases where it is established through comparability analysis that treating costs as pass-through costs is at arm’s length (i.e. no markup or margin is required on pass-through costs), such pass-through costs should be excluded from the cost base of the taxpayer. Accordingly, where the TNMM is applied considering a cost-based NPI, the cost should exclude pass-through costs. In such a case, the NPI would be calculated as follows:

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\text{NPI} = \frac{\text{Net operating profit}}{\text{(Total costs – Pass-through costs)}}
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Furthermore, it is necessary to compare like with like: if pass-through costs are excluded from the denominator of the taxpayer’s NPI, comparable costs should also be excluded from the denominator of the comparables’ NPI. However, this can be challenging as, in practice, limited information is available on the breakdown of the costs of the comparables.

4. Conclusion

Whether costs can be treated as pass-through costs is determined by a fact-specific exercise and the onus is on taxpayers to demonstrate why the costs should be considered as pass-through costs. As a first step, the taxpayer should appropriately draft the intercompany agreements, which should clearly show that the taxpayer does not perform any functions or assume any risks in relation to such costs. The agreement should document that the basis of remuneration would be the return on value added costs (i.e. total costs excluding pass-through costs). The second step that the taxpayer should undertake is to conduct and document a detailed functional analysis to substantiate that he is only acting as a facilitator/agent in relation to such pass-through costs. This functional analysis should then be backed by a robust comparability analysis to establish that no markup or margin is required on pass-through costs.

Following such advice would help the taxpayer to strengthen his position on pass-through costs and enable him to present a scientific analysis during the course of a transfer pricing audit.