UNDERSTANDING RESALE PRICE METHOD

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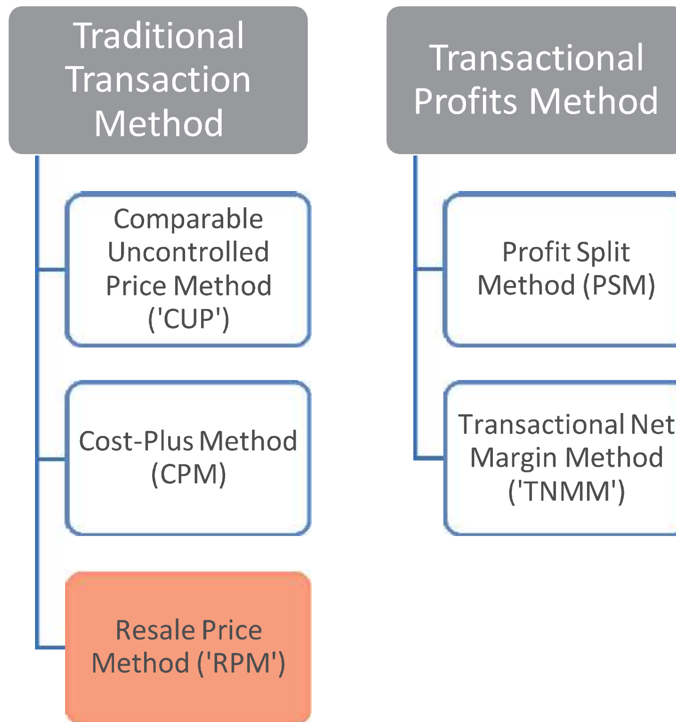
A. Introduction

Any international transaction entered by a Multinational Enterprise ('MNE') with its associated enterprise, is required to be undertaken at arm's length price (ALP) and ALP is required to be determined using one of the 6 methods prescribed under section 92 C of the Income Tax Act, 1961.

In this article, we will focus on the Resale Price Method, commonly termed as RPM, one of the 6 methods prescribed under the Indian Income Tax Regulations which is applied to determine the arm's length price of certain international transactions.

The guidelines issued by the Organisation for Economic Co-operation and Development ('OECD') also suggests determining ALP of international transactions using either Traditional Transactions Method or Transactional Profits Method.



B. Importance of Choosing the Most Appropriate Method ('MAM'):

Determination of ALP of a transaction involves scrutinising the outcome of such related party transactions by comparing them to the outcome if the same had been undertaken between unrelated third parties under similar circumstances. The TP Methods serve as an important pointer to evaluate the ALP of an international transaction. Various metrics such as gross profits, prices, operating profits, financial ratios come into play depending on the type of the TP method applied.

While evaluating the best-fit TP method for a transaction, it is crucial to weigh the strengths and weakness of each of the methods. The decision to apply a certain TP method also involves the availability of data and assessing the degree of comparability of the available data.

C. Resale Price Method

RPM analysis aims to determine the arm's length gross margin earned by an entity on the resale of products purchased.

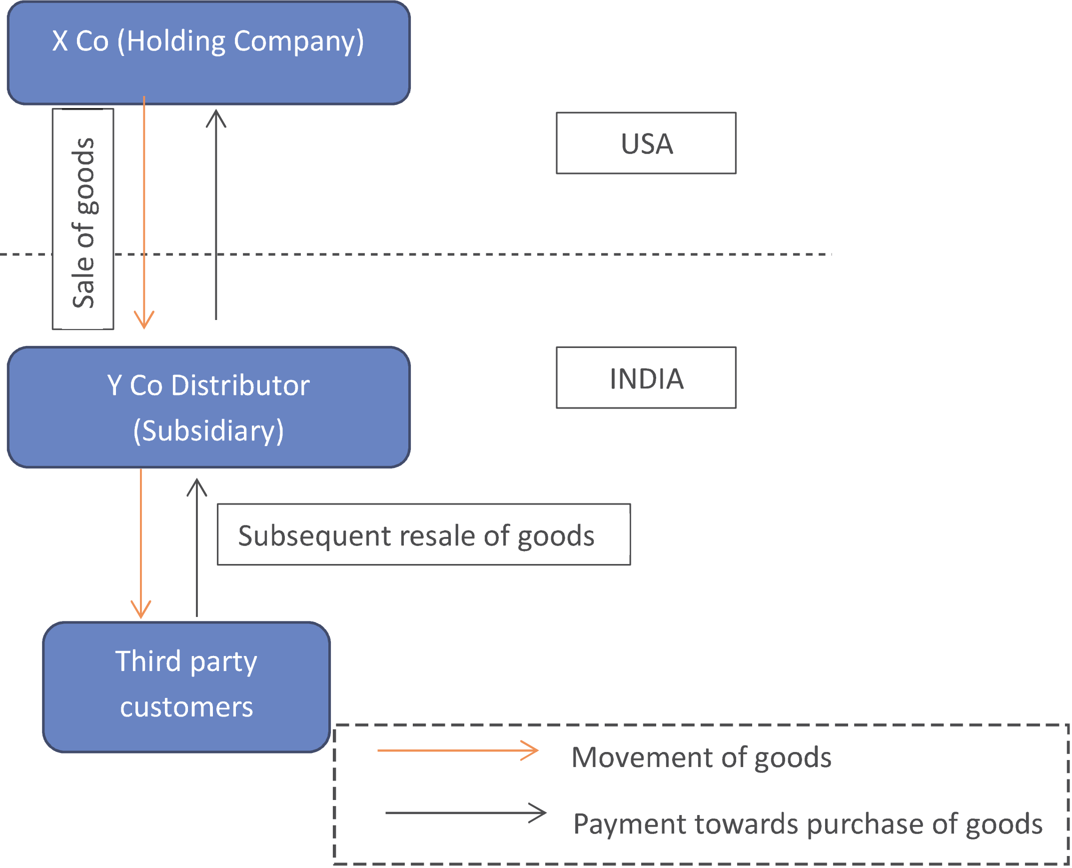
(i) ***What is RPM*** – RPM is a transfer pricing method used to determine the arm's length price of goods that are primarily procured from related parties and subsequently resold to third parties without any substantial value addition.

(ii) ***When to use RPM*** – RPM is typically used when a distributor purchases goods from related parties and sells the same to third parties. During such distribution activity, the distributor acts as a reseller and the goods/products does not undergo any change in its form.

(iii) ***How should RPM be used*** - The price at which the goods/ products are resold to customers is reduced by the normal gross margins earned by unrelated third parties to arrive at the arm's

length purchase price. Under RPM, gross margin is used as the Profit Level Indicator. The primary focus of RPM is to evaluate the price at which the products/goods are purchased from related party by comparing the gross margin at which the same is sold to a third-party customer vis-à-vis gross margin of the comparable companies. RPM could be applied only in case of tangible related party transactions.

D. Instances where Resale Price Method could be applied



In the above example, Y co can adopt resale price method to benchmark the transaction relating to purchase of goods from its parent entity X Co. The gross margin of the uncontrolled transaction between a distributor and third-party manufacturer is deemed appropriate because the market dictates the price. By applying the resale price method, the distributor can ensure that the transactions are being carried out at arm's length. RPM is useful when the companies are performing similar functions. The importance of functional comparability over product comparability for adopting RPM as MAM has also been emphasised in the Guidance note issued by the ICAI.

E. Computation of Gross Profit Margin under RPM

To arrive at the arm's length gross margin under RPM, the following steps are required to be followed:

1. Identify the purchase price of the goods/products procured from associated enterprise which is subsequently resold to third-party customers;
2. Determine the resale price of the products that is transferred;
3. Arrive at the gross margin earned on such resale;
4. Reduce the direct expenses incurred in connection with such resale;

5. Arrive at the gross profit margin;
6. The gross margin so arrived is compared with the gross margin earned by comparable companies under uncontrolled circumstances.

Under RPM, ALP = Resale Price – Gross Profit Margin

F. Comparability requirements in RPM

While evaluating the applicability of RPM, the taxpayer should consider functional comparability between the tested party and the independent comparable companies. The following factors should be considered to evaluate the functional comparability:

- The functions performed by the reseller and the comparable companies should be same or similar, i.e. in purchase, reselling, marketing and distribution functions;
- If any party undertakes value added functions such as customisation/branding, it would affect the pricing, hence such entities should not be considered during comparability analysis;
- When there is functional comparability between the entities, the nature of products/similarity of products is not required to be considered for evaluating the applicability of RPM;

- The risks undertaken both by the reseller and the independent comparable companies should be similar.
- The nature and type of assets used (warehousing/distribution network) should be considered during comparability analysis.

In case the reseller i.e. tested party of the identified comparable companies perform any additional functions, or takes more risks, then adjustments may be required to be made for the differences in the functions, assets or risks. Certain common comparability adjustments undertaken while applying RPM are:

a) Adjustments towards differences in the method of accounting of inventory between the tested party and comparable companies;

b) Adjustments owing to differences in sales terms i.e. whether on Ex-works/FOB/CIF basis;

c) Economic adjustments owing to differences in working capital, customs duty, forex fluctuations, etc.

G. Key Economic Circumstances to be considered when using RPM

In addition to the comparability analysis, economic circumstances surrounding the transaction play a key role in determining whether the selected method is appropriate.

(i) *Overall market environment* – Factors like demand, competition and pricing trends could have an influence on the pricing.

(ii) *Operational efficiency of the reseller* – The financial health of the tested party could have an impact on the pricing. i.e. if the reseller is financially stronger, the bargaining power and the flexibility in applying higher mark-ups is more.

(iii) *Geographical conditions* – If the reseller operates in a market with high labour costs, taxation, trade tariffs, inflation, currency fluctuations and regulatory constraints might have an impact on the pricing.

Adjustments to the resale price based on factors like market conditions, geographical factors, competition, risk profile, are necessary to ensure that the transaction between related parties adheres to the arm's length principle.

Owing to the above factors, taxpayers should consider whether any true-up/true-down adjustment is required to align the transaction price with ALP. Since the primary transaction for the distributor is purchase of goods, any year-end adjustment would have an impact on the purchase price. In case of true-up adjustment in the distributor's books, the cost of purchase will

have to be reduced but related customs duty costs on the same cannot be recovered and is a sunk cost in most of the countries. However, in case of true-down, the purchase cost would be increased, therefore the revised purchase price needs to be declared to the customs authorities and additional customs duty on the same would be payable. Hence, for any distributor, appropriate implementation of the transfer pricing policy is the key.

H. Use of Transaction Net Margin Method (TNMM) for a Distributor

On a plain reading about RPM, many wrongly conclude that RPM is the most appropriate method to benchmark the transactions in case of a distributor. However, the decision/ choice of the method depends on the facts of each case.

Before any transfer pricing method is proposed to be adopted to justify an international transaction, it is imperative to have a detailed understanding of the functions, assets and risks of the entity and its associated enterprise.

Therefore, though RPM can be considered as the most appropriate method for a distributor in many cases, one should be prudent while selecting any method/ appropriate PLI since the same depends on the actual functions performed and the

risks borne by both the parties to the international transaction and other economic circumstances

In addition to application of RPM, OECD guidelines suggest use of Berry Ratio as financial indicator for determining ALP in case of certain distributorship arrangements. The "Berry Ratio" (commonly a PLI used under TNMM) is used in the transfer pricing analysis to compare the ratio of a distributor's gross profit to its value added/operating expenses vis-à-vis third-party comparable companies. This ratio was formulated essentially to evaluate the return on value added services earned by distribution companies i.e. this ratio could be best used to analyze the profitability of a distributor undertaking significant value addition to the product & engaged in performing marketing services.

Berry Ratio = Gross Profit/Operating expenses

The above ratio was formulated with the idea that the cost relating to value added activities would be included in the operating expenses.

I. Interplay between RPM and Berry Ratio

Berry Ratio is one of the most misused PLI during the transfer pricing analysis at the time of transfer pricing audits, due to potential misinterpretation of the facts. Though Berry Ratio and

RPM are tools used under transfer pricing analysis, they both serve different purposes. To assess whether a pricing method or structure is reasonable in relation to a company's profitability, it is imperative to understand the actual functions of the entity i.e. to understand the actual **conduct** of the entity's functions.

- Resale Price Method

RPM focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis. RPM is more appropriate in a business model when the entity performs basic sales, marketing and distribution functions and there is little or no value addition by the reseller prior to resale of goods. The OECD guidelines also uphold that RPM can be used when the reseller does not add substantial value to the products. However, when the goods/products purchased from the AE are further processed and when the identity of the purchased goods is lost, RPM cannot be applied.

- Berry Ratio

Berry Ratio was formulated by Professor Charles Berry, who proposed it as a substitute of resale price and cost-plus methods under US transfer pricing regulations. Berry ratio is most useful when operating expenses are used as a measure of profitability in distribution business.

When the MNE's create centralised hubs for selected value-added activities like procurement and distribution with low/ limited functional and risk profiles, Berry ratio could be used. In cases where one subsidiary performs marketing or distribution services, Berry ratio could be an useful tool to assess whether such subsidiary is receiving appropriate return in relation to the operating expenses incurred.

In summary, **RPM** determines the arm's length price by adjusting for the reseller's gross profit, while the **Berry Ratio** provides insight into the overall profitability, especially related to operating expenses. Berry ratio could therefore be applied in case of a limited risk distributor whereas, RPM could be applied in case of a full-fledged distributor who do not perform significant value addition to the products before resale.

It could be observed that the level of activities performed by the reseller, i.e. either acting as an agent, buy-sell distributor, those taking flash title like sogo-shosha companies, has an effect on the resale price margin. Therefore, the functional analysis and the characterisation of the tested party serve as a primary indicator for choosing the MAM. The different type of distributors and their functional and risk profile is tabulated below for ease of understanding:

Particulars	Limited-Risk Distributors ('LRD')	Full-fledged distributors ('FFD')	Commission Agents	Sogo-Shosha distributors
Background	LRD's operate under close supervision of their parent and has limited risk profile.	FFD's undertake both operational and entrepreneurial functions and manage the entire distribution and sales process right from purchase of goods from AEs till sale to the end customers.	Typically operates as a sales representative, by identifying customers and acting as intermediary between the purchaser and seller.	Sogo-shosha are Japanese trading companies that import and export products and also provide logistics and related services. They operate in array of industries and have extensive global network.
Functions performed	Performs all sales and distribution functions like procurement, storage of goods and shipping them to customers, but under the close control and supervision of the parent company. They do not get involved in strategic decision making activities.	Performs all sales and distribution activities and the risks for performance of the functions. They also hold strategic marketing responsibility. Their functions include undertaking market research, developing marketing materials, advertising and developing marketing plans.	Performs sales functions like identification of customers, introducing new products, maintains customer relationship.	Performs the functions similar to a middleman, brokers or intermediaries and deal with massive range of products. They only take flash title to goods. These entities also undertake logistics and transportation services for distribution of the products. The functions performed are merely in the nature of distributors.
Risks	Parent Entity/AE help mitigate inventory risk, market risk, credit risk.	Bears all the risks associated with the performance of the above functions – i.e. bears market risk, inventory risk, credit risk.	Does not take title to goods and therefore does not undertake market risk, or credit risk.	Inventory risk is negligible as they hold only flash title to goods.
Return	Earns stable margins without developing significant marketing intangibles.	Remunerated based on the functions performed and its risk appetite.	Receive commission at a certain percentage on sale of products.	Earn cost plus appropriate mark-up. Average returns similar to commission agent.
Commonly used Transfer Pricing Method	TNMM –return on sales	TNMM/Resale Price Method	CUP- in case of external CUTs.	TNMM (Berry ratio could be adopted as PLI)

J. Benefits and Limitations of using RPM:

Benefits of using RPM

a) Comparability requirements are less stringent than with other methods like CUP, since gross margin is used as benchmark

b) Most effective when there is sufficient data about comparable entities within the same industry

c) Focuses on the functions performed by the reseller to determine appropriate gross margin

d) This method is relatively straight forward to apply since it involves computation of margin at gross level.

Limitations of using RPM

a) Difficult to apply when there are inherent differences in the method of accounting

b) Not suitable for goods with valuable intangibles

c) Cannot be used when the reseller undertakes more value-added activities i.e. useful only for distributors who do not undertake significant value additions to the products.

K. Legal jurisprudence on RPM

There are various judicial pronouncements where the jurisdictional High Courts/Tribunals upheld the use of RPM as the most appropriate method. One could rely on these judgements as a precedence before proceeding to decide on the most appropriate method.

a) India

Case Law Reference	Nature of Issue
Burberry India Private Limited (TS- 505-HC-2024 (DEL)-TP	The Hon'ble High Court held that the assessee is engaged in the import of goods under the brand name 'Burberry' and from its AE and sells the same to its customers. Further, the assessee does not undertake any value addition to the product. Therefore, the High Court concluded that the action of the Tribunal in concluding RPM as the MAM is right.
Jushi India Fiberglass Private Limited (ITA No.1163/Mum/2024)	The Hon'ble Tribunal held that the application of any method as MAM depends on the functional profile of the tested party and based on the facts of the case, RPM was held to be the MAM for the assessee.
Matrix Cellular International Services (P) Ltd (90 Taxmann.com 54)	The Hon'ble Delhi High Court upheld the application of RPM as the most appropriate method where the business of the assessee was that of a pure trader and there was no value-addition made by the assessee before resale of products to customers.
Swarovski India Pvt Ltd v ACIT – TS-91-ITAT-2017 (Del) – TP - ITA No.5622/Del/2014 & ITA No.5497/Del/2014	The Tribunal rejected application of CUP method as MAM by the assessee. Referring to Rule 10B(1)(b), the Tribunal observed that RPM was the MAM as it was applicable where a property was purchased from an AE and resold as such without any value addition and the assessee in the instant case sold the Crystal components imported from its AEs without any value addition. It accordingly remitted the matter to the TPO to benchmark the transactions as per RPM.
KMG Infotech Ltd Vs DCIT (TS-312-ITAT-2017(Bang))	The Tribunal observed that under RPM, focus was more on the similar nature of service, rather than similarity of products. Therefore, the Tribunal held that RPM was the MAM for benchmarking the international transaction in the case of the assessee performing distribution functions in respect of earthmoving equipment.
Randox Laboratories (India) P Ltd IT(TP)A no.507/Mum./2015	The ITAT rejected adoption of TNMM and upheld the use of RPM in case of companies engaged in distribution activity, when the goods are purchased from AEs and sold to customers without further processing.

b) International jurisprudence

Case Law Reference	Nature of Issue
Kenya vs Cummins Car and General Limited, September 2024, Tax Appeals Tribunal, Case no. TAT E450 OF 2023	Cummins Car and General Limited purchased goods from related party and sold them to external customers. The transaction relating to purchase of goods from related party was benchmarked using CUP as MAM. However, the tax authorities were of the view that RPM is the MAM and CUP could not be used since there was significant time lag between the previously agreed prices and the transactions under consideration.
Denmark vs EET Group A/S, June 2024, Court of Appeal, Case No SKM2024.506.ØLR (BS-6035/2021-OLR)	EET Group A/S purchased goods from third party suppliers and resold them to its group companies (EET Group). In the TP document of EET Group A/S, a detailed comparability analysis in the form of comparison of gross margins of the tested party vis-à-vis third parties were included. The Danish Tax Agency increased the entity's income by considering net margin of comparable companies. The Eastern High Court however, ruled that EET Group A/S was right in carrying out the comparability analysis based on gross margins.
GlaxoSmithKline Transfer Pricing Case (Canada) (2012 SSC 52)	Glaxo Canada adopted RPM as the MAM for the purchase of ranitidine, an active pharmaceutical ingredient (API). The Tax Court of Canada favored the CUP Method. The Supreme Court of Canada later addressed this issue and found that the Tax Court failed to consider the license agreement between Glaxo Canada and its parent company, which granted rights to use trademarks, thereby affecting the comparability of the transaction. The Supreme Court of Canada insisted that the roles and functions of both the parties to the transaction to be kept in mind while determining the ALP and directed the Tax Court of Canada to determine ALP.
France vs Ferragamo France, June 2022, Administrative Court of Appeal (CAA), Case No 20PA03601	The Resale Price Method played a crucial role in the Ferragamo France case, serving as a key transfer pricing methodology to evaluate the arm's length nature of the transactions between Ferragamo France and its parent company. The final decision of the Administrative Court of Appeal was made in June 2022. The case elaborated on how an adjustment is required to be made to RPM when a distributor contributes significantly to the brand value apart from being engaged in the sale of products. The key issues relating to RPM discussed in this case were – (i) the additional expenses incurred by Ferragamo and whether the same had an implication of the gross margin, (ii) whether standard distribution margins under RPM are sufficient when the subsidiary actively contributes to brand value and (iii) importance of looking longer-term business trends and market development efforts while evaluating RPM.

L. Conclusion

The Resale Price Method is an essential tool for multinational enterprises seeking to establish arm's length pricing for intra-group transactions, especially in distribution and resale scenarios. By focusing on the resale price and comparing the appropriate gross margin, this method ensures compliance with tax regulations and promotes transparency in pricing. RPM requires a high degree of functionality comparability rather than product comparability. Hence, a detailed analysis showing the close functional comparability and the risk profile of the tested party and comparable companies should be clearly brought out in the Transfer Pricing study report in order to justify comparability at gross profit level under RPM. Understanding the nuances of RPM can help businesses navigate complex tax regulations and optimize their global transfer pricing strategies.

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