Understanding the concept of Pass-through Cost in Transfer Pricing

It is a common practice among some Multinational Enterprises (MNEs) to make payments of expenses or purchases on behalf of other entities within the group. In many cases, the holding company makes purchases/payments of expenses to third parties on behalf of its subsidiaries. This could be for administrative reasons or in a bid to achieve cost efficiency. These costs are usually cross charged to the respective related parties. In the contest of transfer pricing, these costs are referred to as 'Pass-through Costs.'

Pass-through costs are third-party costs incurred by a taxpayer on behalf of a related party. These transactions are carried out with no intention to generate profit since no value-added functions were performed by the taxpayer. Usually, these costs are incurred at market price, hence, the entity passes the cost to its related party at the exact amount charged by the independent party.

One major area of concern in relation to the pass-through cost is whether the cost to be cross charged should be at a mark-up or at the exact amount paid to the independent party. While there is no specific rule in the Nigeria Transfer Pricing Regulations on how pass-through costs should be treated (whether a markup is required or not), the OECD guidelines provides that the facts and circumstances specific to the transaction under review should be considered in determining the correct treatment of such costs.

In examining the facts and circumstances specific to the transaction under review, it is important to consider if any significant functions are performed by the entity incurring the cost on behalf of its related party, and if any risk would be undertaken by the entity. This consideration would determine if a mark-up should be added to the cost or not.

In carrying out a benchmarking study using the cost-plus method, the selected comparables might not include pass-through cost as part of the cost base to prevent distortions. In this case, it is necessary to also remove the pass-through costs from the cost base of the tested party to ensure their comparability. In line with the OECD guidelines, it is necessary to compare like with like, if pass-through costs are excluded from the cost base of the tested party, pass-through costs should also be excluded from the cost base of the comparable and vice-versa. Comparability issues may arise in practice where limited information is available on the breakdown of the costs of the comparables.

Providing Remuneration for Pass-Through Arrangements

As stated earlier in this article, one major area of concern in relation to the pass-through cost is whether the cost to be cross charged should be at a mark-up or at the exact amount paid to the independent party. This concern is justified from a perspective of ensuring that parties are fairly compensated for assets utilized, as well as risks assumed in related party transactions. There are circumstances that lead to the application of mark-up on the pass-through costs. According to the OECD guidelines, when a related party is acting only as an agent or intermediary in the provision of services, it is important in applying a cost-based method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself.

Consider a few examples from the OECD guidelines:

- A parent company outsources certain services to an independent party and decides to engage one of its subsidiaries to act as an agent for the group. Its only role as an agent is to pay the independent service provider and allocate the total cost of services among group members using an allocation key. In such a case, it may not be appropriate that the related party receives a mark-up on the cost of the outsourced services, rather, the agent's compensation could be based on the costs of the agency function itself and the outsourced costs could be allocated among members of the MNE without mark-up.

- A related party may incur the costs of renting advertising space on behalf of group members; costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function.

- An MNE has a parent company, in Country A and has a subsidiary, in Country B. The parent company has a total of 10 subsidiaries globally. The MNE has decided to outsource the group's human resources (HR) activities to an independent entity in Country B, through its subsidiary in Country B. The role of the subsidiary in Country B is to pay the independent enterprise and in turn recharge the costs to group members. In this situation, the subsidiary in Country B is operating as an agent. The subsidiary passes on the service costs charged by the independent company without a profit mark-up to the MNE group members using an allocation key based on full time employee equivalents. The charge is on a pass-through basis as the subsidiary is not adding value but rather merely used for convenience to distribute the HR costs of outsourcing to independent company.

Based on the examples above, where the taxpayer performed value addition for the service provided by the third party, or where an agency function has been performed or where intra-group service has been performed, then a mark-up can be applied.

The Nigeria Transfer Pricing Regulations does not have a specific treatment on pass-through costs neither are there decided cases on the concept of pass-through costs. However, it is useful to examine the Indian case of Cheil Communications India Private Limited v. DCIT (2010) (Delhi) which reviews this concept.

Cheil Communications India Pvt Ltd (the assessee), is a wholly owned subsidiary of Cheil Communications Inc. Korea (Cheil Korea). It engages in providing advertising, communications, and other related services to its related parties.

The assessee facilitates placements and payments on behalf of its related parties for advertisements on hoardings space and print and electronic media. These payments were reimbursed by the related parties to the assessee. The third-party payments by the assessee do not represent any value-added functions undertaken by the assessee. Hence, when preparing its transfer pricing documentation for financial year 2004-2005, the assessee only included a mark-up on the cost it incurred while performing the agency function and excluded all pass-through cost (e.g., the costs of renting the hoarding space).

The tax authority rejected the approach stating that mark-up should be on the total cost (both the cost incurred while carrying out the agency function and the pass-through costs).

The Indian tax tribunal in its judgement, held that the mark-up should be applied to the cost incurred by the assessee in performing its agency function, and not to the cost of renting advertising space on behalf of the related party (pass-through cost). The assessee simply acts as an intermediary between the related parties and the third-party vendor to facilitate placement of the advertisement. The payment made by the assessee to vendors is recovered from the related parties on a cost-to cost basis. In the event the related party fails to pay any such amount to the advertisement agency for the cost of renting the advertising space, the bad debt risk is borne by the third-party vendor and not by the assessee.

From the above case, it is observed that expenses incurred in a transaction are considered pass-through costs when the following attributes are present:

- The taxpayer does not perform any value adding activities to the products/services provided by third-party vendors or service providers. The taxpayer only acts as an intermediary or an agent. In this case, mark-up is only applicable on the cost incurred while performing the agency role.

- The taxpayer does not bear any risk in relation to the expenses incurred.

Conclusion

It is not uncommon for entities within the same group to make payment of expenses to third parties on behalf of each other. This usually gives rise to 'pass-through cost'. However, the Nigeria Transfer Pricing Regulations does not provide specific guidance on the treatment of Pass-through Cost. Drawing from the OECD guidelines, it is important that taxpayers maintain adequate transfer pricing documentations to support transactions conducted among related parties. This is to ensure that the transaction pricing is reflective of assets utilized, as well as risks assumed. The taxpayer also has the burden of proof to demonstrate that no additional function was performed in a pass-through transaction. It is essential that the facts and circumstances of the transactions be considered in determining whether a mark-up is applicable on a pass-through transaction. Experience has shown that this is usually a grey area during transfer pricing reviews by the tax authorities.

This article was written by:

Emmanuel Oketokun
Senior, Tax & Regulatory Services

Folakemi Ogunyemi
Senior, Tax & Regulatory Services

For enquiries on this article and more, kindly contact us via technicaldesk@mazars.com.ng