Transfer Pricing challenges and solutions in Logistics Industry

In this article author Akshay Kenkre of TransPrice Solutions, India, analyses different business models in Logistics Industry with focus on freight forwarding business and provides guidance on plausible transfer pricing methodology that may considered under each of the business models.

Introduction

There was a time when the most important rule decision for business was location. If the business was located closer to its target market it was suppose to have competitive edge over others. Further to do business globally would demand setting up operations in respective countries. However, times have changed and the need for proximity to target market has been supplanted by a new force in business i.e. logistics.

Business logistics is defined as “having the right item in the right quantity at the right time at the right place for the right price in the right condition to the right customer”. According to Council of Logistics Management, logistics is “the process of planning, implementing, and controlling the efficient, effective flow and storage of goods, services, and related information from point of origin to point of consumption for the purpose of conforming to customer requirements.”

Logistics activities fall broadly into three types of services: (a) warehousing; (b) freight forwarding and (c) transportation. These businesses are deeply interconnected, with some overlapping. From the transfer pricing perspective freight forwarding is the area of service which involves high volume of cross border transactions. In this article we shall discuss the functions and activities involved in freight forwarding business, commonly adopted business models and based on the business model provide guidance on plausible transfer pricing methodology that can be adopted by the taxpayers.

Functions and activities involved in freight forwarding business

Freight forwarders act as coordinator for movement of goods from place of origin to place of designation. In discharging this function they bringing various third party service providers (such as a airlines, shipping lines, transporters, clearing and forwarding agents, etc) to a common platform to provide integrated logistics services to a customer. International freight forwarding business can be either inbound or outbound. To illustrate this let us take an example: a company in India wants to ship a cargo of goods from its warehouse in India to its subsidiaries warehouse in USA. This will be an outbound consignment for freight forwarder in India (in this case Indian freight forwarder is “Origin Company” while USA freight forwarder is “Destination Company”). Almost similar coordination functions will be performed by Origin and Destination Company. The USA based freight forwarder can be either a member of Group Company or in absence of group member, an independent freight forwarder.

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2 http://www.asianclm.com/index.htm
Continuing the above example, some peculiar functions that may be performed by Origin Company (i.e. Indian freight forwarder) and Destination Company (i.e. USA based freight forwarder) which distinguishes this business from any other business are as follows:

1. **Freight handling function**

*Functions Performed by the Origin Company (‘OC’)*

Some of the significant functions performed by the OC are:

- **Transportation to point of exportation**
  The OC hires the services of a third party transporter (such as trucker, etc) for the transportation of the shipment from the client’s facilities (in our example from warehouse of client in India) to the point of the shipment which can be either an airport or seaport as agreed with the client.

- **Custom clearance**
  The OC helps the client with customs related formalities and documentation (in our example customs clearance from India) so that the shipment is cleared by the authorities without any complications and is ready for transportation.

- **Coordination with international transport companies (i.e. Airlines or Shipping lines)**
  The OC Co-ordinates with the international transport company (airline or shipping line as the case may be), negotiates for availability of cargo space and charges. Ensures that the cargo is loaded on board of the vessel.

- **Documentation**
  Logistics being a document-intensive business, the OC does necessary documentation and dispatches the same to Destination Company so that there is no problem in releasing goods.

*Functions performed by Destination Company (‘DC’)*

Some of the significant functions performed by the DC are as follows:

- **Shipment tracking and processing documents received from OC**
  In freight forwarding business the responsibility of managing movement of cargo passes with actual movement of goods. In our above example once the shipment has been dispatched from Airport or Sea port in India the responsibility of managing the movement of cargo is passed on to the DC. The DC scrutinizes the documentation received from the OC to ascertain whether they are complying with local regulations or not, coordinates with the international transport service provider (i.e. Airlines or shipping lines) and tracks the goods on real time.

- **Preparing necessary shipment release documentation and intimating the consignee**
  DC prepares necessary documents to release shipment. DC does customs clearance formalities to be release the shipment.

- **Transportation from port to place of destination**
  The DC hires the services of a third party transporter (such as trucker, etc) for the transportation of the shipment from the Airport or Sea Port or CFS to the point of the destination which in our above example is warehouse of client’s subsidiary.
2. Other functions performed

Like any other business freight forwarders (i.e. both OC and DC) perform functions like marketing their services, new offerings, price negotiation with customers, etc.

**Cross-border transactions in international freight forwarding business**

Logistics companies manage movement of cargo from place of origin to place of destination through network of its group companies in various parts of the world. However, it may happen that in a particular country the group does not have a member company. In such case the ultimate parent company of the group usually enters into an agreement with independent local freight forwarder in the country where it does not have presence. Such arrangements ensure that services demands of the customers are met.

In case where group has presence in both country of origin and country of destination, the movement of cargo is managed within the group and all the function as mentioned above are performed by OC and DC. If the OC collects the freight forwarding charges from customer then it compensates DC for its part of functions undertaken and vice-a-versa. Thus remuneration for managing movement of cargo paid to the counter party (i.e. freight payment) is one of the significant cross border transactions in logistic company. In case of inbound transaction or where freight is collected by DC the cross border transaction for Indian logistic company will be that of freight receipt. Different logistics companies have adopted different model of remunerating OC or DC for its functions. These different models and their transfer pricing implications are discussed in the following paragraphs.

**Typical business model and applicable transfer pricing method**

1. **Net Revenue Split model**

The premise of this business model is that both the OC and DC perform comparable functions; i.e., they coordinate with third party service providers (such as clearing and forwarding agents, airlines, transporters, assist in loading and unloading the cargo, etc) to provide integrated logistics services to the client. According to this model the net revenue collected from the customer should be split between OC and DC in some ratio. Some companies adopt 50:50 split of revenue between OC and DC while some adopt 70:30 split whereby OC keeps larger share. There are other variations as well to this model. To illustrate this model let us take an example:
Say of example for movement of cargo from India to destination in USA, an Indian logistic company charges USD 100. Third party cost on transportation at both ends is say USD 15 at each location and air/ shipping lines charges 50 USD.

In the above example say the OC and DC share net revenue in 50:50 ratio, the working of the net revenue split will be as follows:

<table>
<thead>
<tr>
<th>Working of 50:50 revenue split</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amount collected from customer</strong></td>
</tr>
<tr>
<td>Less: Payment to third party service provider</td>
</tr>
<tr>
<td>Local transportation in India</td>
</tr>
<tr>
<td>Local transportation in USA</td>
</tr>
<tr>
<td>Airlines/ Shipping lines charges</td>
</tr>
<tr>
<td><strong>Net revenue</strong></td>
</tr>
</tbody>
</table>

This net revenue of USD 20 will be shared equally between OC and DC. Thus share of OC will be USD 10 and that of DC will be USD 10. In this case DC can either be member of MNE group or independent freight forwarder (in absence of group company).

Transfer pricing methodology

In the above illustration if the DC is member of group then the OC (i.e. the taxpayer in India) will be required to justify arm’s length nature of its transactions of splitting net revenue (in the example, of USD 20) between itself and the DC. As mentioned earlier logistics companies do enters into agreement with independent logistic service provider in such countries where they do not have any member company. Usually the ultimate parent company enters into agreement with independent logistic service provider in such countries.

In case where there are such independent party arrangements, the best practice to defend revenue split model from transfer pricing perspective is to identify identical agreement with independent logistic company for freight forwarding services. The terms & conditions of these agreements should be analysed to see how net revenue is agreed to be split between OC and DC. If the terms & conditions of such independent party agreements are identical to that of agreement with related party, this can be a basis for defending split of net revenue in related
party transaction. However, these agreements itself will not suffice to justify arm’s length nature of transactions with related entity. The logistic company will also have to demonstrate evidence that transaction(s) have actually been undertaken with independent freight forwarder. This will require logistic companies to document the working of net revenue split with its group companies as well as with independent service provider. Such independent agreement and working of net revenue split in actual transactions with third party freight forwarder can be considered as internal comparable uncontrolled price (i.e. internal CUP). This demonstrates that the logistic company (in our example an Indian taxpayer) is following consistent policy of splitting net revenue in equal ratio while transacting with its related entities as well as with independent logistic company.

At this point it is worth to mention a landmark transfer pricing ruling in India for logistics industry i.e. the ruling of Agility Logistics Private Limited3. In this case Agility Logistic Private Limited (hereinafter: Agility India) followed an approach of splitting net revenue from freight forwarding business in 50:50 ratio between OC and DC. This approach of splitting net revenue in 50:50 ratio was consistently followed while transacting with related party as well as with independent freight forwarders in those countries where the Agility Group did not have presence. The Income Tax Appellate Tribunal in this case upheld the model and inter-alia ruled as follow:

• The terms and conditions in the agreements between related parties and the independent freight forwarders we substantially the same;

• The revenue split information contained in all the agreements is same and is typical to the industry; and

• Geographical differences are not material so far as it applies to the logistics industry.

Thus, the independent party agreements and actual transactions indicating split of net revenue in 50:50 ratio was considered as internal CUP.

2. Rate card model

Under this model each company in the group from a particular country has a different rate (per file, per kilogram, etc for both inbound and outbound cargo) of transacting with another member of the group located in different countries. For example, Indian company being a member of group charges USD 10 per kilogram for inbound transaction and will pay USD 8 per kilogram while transacting with group company in USA.

Transfer pricing methodology

Using CUP method to defend this model is very difficult as the rates differ from country to country. Best way to defend this model from transfer pricing perspective is to use Transactional Net Margin Method (hereinafter: TNMM). In this case taxpayers can evaluate the use Operating Profit to Value Added Cost (hereinafter: OP/VAE) as profit level indicator. Thereby the third

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3 Agility Logistics Private Limited [TS-47-ITAT-2012(Mum)]
party costs like local transportation cost, carriage charges of airlines/ shipping lines, etc are considered as pass through costs.

3. Cost plus model

In this model one of the group company (mostly ultimate parent company) is considered as entrepreneur entity in the group and the other members of the group company located in different country are positioned as low risk service provider. These entities are compensated on cost plus basis by parent company. The parent company enters into contract with the customers and sub-contracts the relevant portion of the transactions to its subsidiaries in different countries.

For example in case of out bound transaction where the customer from India wants to move goods to USA, the Indian arm of the parent company will perform the India side of coordination functions (like custom clearance, pick of cargo from customers warehouse through third party transport company, etc) and also collect the freight forwarding charges from the customer. The freight charges so collected will be transferred to ultimate parent company and the Indian company will receive cost plus mark-up for its services. Similarly the USA member of the group will perform its part of functions and get remunerated on cost plus mark basis by ultimate parent company. The entrepreneur risk and rewards reside with parent company which controls the network of member companies. However, nowadays this model is not so prevalent.

Transfer pricing methodology

Cost plus method (hereinafter: CPM) may be considered as an appropriate method for conducting the arm’s length analysis. Application of CPM requires a comparison of gross profit mark-up arising in the related party transaction with those arising in comparable uncontrolled transactions. However, if is possible that the way financial statements are prepared by the comparable companies it may be difficulty or rather impossible to determine gross profit mark-up. Thus, in such case one has to fall back to TNMM for determining arm’s length nature of transaction.

Conclusion

While there can be few more models in the logistic companies as this industry is evolving very fast with globalization of world economy. Logistics industry is undergoing a change to a system wherein a dedicated player handles majority of a company’s logistics operations. These players are referred to as 3PL players who typically specialize in integrated transportation and warehousing services that can be customized to meet the company’s needs.