Chapter 5
Intercompany Sale of Diamonds

This segment contains a series of detailed case studies, each of which is composed of (a) a summary of key facts, (b) a description of the transfer pricing issues raised, (c) an analysis under the existing transfer pricing regime (where feasible), (d) an alternative analysis under one or more of the proposed methods, and (e) a comparison of the methodology and results under existing and proposed methods (where the transactions at issue can be analyzed under both regimes). All of the proposed methods discussed in Part II are illustrated by at least one, and in some instances multiple, case studies.

Our first case study involves a three-member controlled group in the business of purchasing rough diamonds, having a portion of them cut and polished, and reselling stones in both rough and polished forms at the wholesale level. The parent company (FP), based in Belgium, is a sightholder. It purchases parcels of rough diamonds from De Beers, for sale exclusively to a subsidiary in Israel (IS). IS relies on both FP and third parties for its supply of rough stones and owns certain proprietary designs and trademarks. It has some of the rough stones cut and polished by third party cutters, in accordance with its proprietary designs and some generic designs. It sells generic polished stones both to FP’s U.S. subsidiary (USS) and to third parties in non-U.S. markets. IS sells polished stones cut to its proprietary designs exclusively to USS. All of IS’ rough stone sales are to third parties. USS purchases stones primarily from IS, supplements these purchases with third party purchases when necessary, maintains inventories and resells to high-end jewelry retailers in the United States.

We analyze the various transactions in this case under the resale price method, the comparable profits method, the numerical standards approach and the modified inexact comparable uncontrolled price method. Our analysis under the latter method necessitates a fairly extensive discussion of market structure, competitive dynamics and the pricing of diamonds. Moreover, the trademarking of diamonds is a comparatively recent phenomenon, motivated by a wide range of considerations that go far beyond traditional product differentiation at the consumer level; correspondingly, the funding and ownership of trademarks tend to be more diffuse in the diamond industry than in other luxury goods markets. Because this fact has important implications for our transfer pricing analysis, we address the issue of branding in detail as well.
5.1 Summary of Key Facts

The diamond industry is segmented into a number of distinct market levels, collectively referred to as the “diamond pipeline” by industry participants:

- Diamond mines, located primarily in Angola, Australia, Botswana, Brazil, Canada, Ghana, Guinea, the Ivory Coast, Namibia, the Republic of Congo, Russia, the Sierra Leone and South Africa;
- Dealers of rough stones;
- Cutters and polishers, among them standalone entities that perform cutting and polishing functions on a fee-for-service basis;
- Wholesale distributors; and,
- Retailers.

The number of industry participants operating at each market level progressively increases as one moves along the diamond pipeline toward retailers and end-users. There are comparatively few mines, a relatively limited base of rough stone dealers, a larger number of wholesale distributors and upwards of 40,000 retailers in the United States, 25,000 retailers in Japan and 60,000 retailers in Europe. Industry participants are vertically integrated to widely varying degrees. Moreover, a subset of mines operates through a long-standing cartel that limits the supply of rough stones, both in aggregate and through particular marketing channels. As described in greater detail below, the cartel’s modus operandi has largely shaped the structure of downstream market segments, although its influence has diminished significantly in recent years.

5.1.1 Historical Dominance of De Beers

The diamond industry has historically been dominated by De Beers. Together with the Diamond Producers’ Association (an association of mine operators), these entities form the nucleus of the DTC (successor to the Central Selling Organization, or “CSO”), the aforementioned cartel. The DTC’s primary objective is to maintain high and stable prices for rough (and thereby, polished) stones. It has historically influenced the prices of rough and polished diamonds primarily, albeit not exclusively, through supply-side measures (e.g., production quotas and the maintenance of very large buffer stocks). This has been feasible because the cartel has historically controlled a very high proportion of all rough stone production.

Thus, for example, during the early 1990s, De Beers controlled approximately 70% of all diamond mine production and approximately 85% of rough diamond distribution through the CSO; such control was exercised through a combination of outright ownership, partnerships, structured finance deals and exclusive supply and marketing arrangements. A typical rough diamond supply contract with the DTC involves selling run-of-mine production thereto for cash at a 10.0% discount from the DTC’s Standard Selling Values (SSVs). The DTC guarantees to buy producers’