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Expenditure of new product samples to be given to third party distributors, disallowed in hands of wholesale trader

The Bangalore Bench of the Income-tax Appellate Tribunal (ITAT) rendered its decision that the burden to incur expenditure of new product samples (to be given to the third-party distributors) is that of the manufacturer and thus, disallowed in the hands of the related party wholesale trader

Background:

- The taxpayer¹ is engaged in the business of importing footwear, apparel, sports equipment and accessories for wholesale trading in India. The taxpayer is a wholly owned subsidiary of a Netherlands based entity, which in turn is held by a USA based entity (US entity).
- During the Financial Years (FY) 2011-12 and 2013-14, corresponding to Assessment Years (AY) 2012-13 and 2014-15 respectively:
 - The related party of the taxpayer, i.e. the US entity had introduced new products and accordingly sent samples to the taxpayer for giving the same to the third-party distributors, who were required to display the same in their premises. The objective was promotion of new products.
 - The US entity had charged the taxpayer towards cost of samples given to it.
- The Assessing Officer (AO) held that the taxpayer was only a distributor of the products and hence the expenditure on samples should be borne by the manufacturer only. The manufacturer should not pass on the burden to the taxpayer. Accordingly, the AO held that the expenditure on purchase of samples and incidental expenses were not related to the business activities of the taxpayer and disallowed the same for both FY 2011-12 and FY 2013-14, corresponding to AY 2012-13 and AY 2014-15, respectively.
- On appeal by the taxpayer, the Dispute Resolution Panel (DRP) confirmed the disallowance made by the AO.

Aggrieved by the final order of the AO (under the directions of the DRP), the taxpayer filed an appeal before the Bangalore Bench of the Income-tax Appellate Tribunal (ITAT) for both the years.

Decision of the ITAT:

- The ITAT noted that this expenditure was a matter of transfer pricing adjustment in AY 2010-11 and AY 2011-12 wherein, the transfer pricing adjustment was confirmed by the ITAT. The decision was rendered by following the decision rendered by the co-ordinate Bench in taxpayer's own case for AY 2005-06 and AY 2006-07.
- Further, the ITAT noted the following:

¹ Nike India Private Limited Vs. DCIT IT(TP)A Nos.330/Bang/2015, 804/Bang/2016, 356/Bang/2017, 739/Bang/2017 & 3321/Bang/2018

- There was no dispute that the US entity had introduced new products and the samples were supplied to third party distributors in order to create awareness of new products amongst the public.
 - The taxpayer was merely an intermediary between the US entity and the public. Hence, it was the responsibility of the taxpayer to show that the expenditure on samples and incidental expenditure was incurred for the purposes of business of the taxpayer.
 - The co-ordinate Bench of the ITAT [in the context of advertising, marketing and promotion (AMP) expenses] had taken the view that the sample expenses were related to brand promotion and marketing initiatives of the US entity. Therefore, it could not be said that the expenditure had been expended wholly and exclusively for the business of the taxpayer.
 - It was a known fact in trade circles that the expenditure on samples were borne by the manufacturers only.
- The ITAT dismissed the contention of the taxpayer that the AO could not question the necessity of incurring the expenditure on the basis that, when the transaction was between related parties, more burden was placed on the taxpayer to prove that the expenditure was related to the business of the taxpayer.

Based on the above, the ITAT held that the claim of expenditure was against the trade practice and the taxpayer appeared to have borne the expense only on the basis that the same was charged to the taxpayer by the US entity. Accordingly, the ITAT held that the AO was justified in holding that the burden to incur the expenditure was that of US entity and was not related to the business activities of the taxpayer and confirmed the disallowance made by the AO.

Comment:

Whether a particular expenditure has been incurred for the purposes of business of the taxpayer is question of fact and has been subject to litigation. This ruling has held that, in case the manufacturer and the wholesale trader are related parties, then the burden to incur expenditure of new product samples (to be given to the third-party distributors for display at their premises) is that of the manufacturer and accordingly, is not related to the business of the wholesale trader.

Taxpayers with similar supply-chain arrangement amongst group companies, may want to consider impact of this ruling to the facts of their case.



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