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Marketing Intangibles – A Different Approach?

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Executive Summary

Income Tax Appellate Tribunal, Delhi Bench (the Tribunal) recently pronounced an important ruling in the case of Luxottica India Eyewear Pvt. Ltd. (LIEPL, the taxpayer, the company) on marketing intangibles, pertaining to three assessment years (AY) - 2010-11, 2011-12 and 2012-13.

For the first two years under litigation, i.e., AY 2010-11 and AY 2011-12, the TPO had applied the bright line test (BLT) and treated excess advertising, marketing and promotion (AMP) expenses, as a separate international transaction. In doing so, the TPO alleged that the taxpayer was developing the brand of its associated enterprise in India and for that, the taxpayer was not remunerated, in line with the arm's length principle. For the third year under litigation, i.e. AY 2012-13, the TPO deviated from the above approach and made an adjustment on account of difference in intensity of marketing function undertaken by the taxpayer vis-à-vis its comparables.

The Tribunal remanded back the matter pertaining to AY 2010-11 and AY 2011-12 with a direction to the AO/ TPO to relook at the cases, in line with the decision of the Hon'ble Delhi High Court in the case of Sony Ericsson*, as well as taxpayer's own case in earlier year(s).

For AY 2012-13, the Tribunal accepted the approach of the TPO by placing reliance on judgements of the Hon'ble Delhi High Court in the case of Bausch and Lomb and Sony Ericsson* wherein the court had stated that the comparables chosen should be undertaking similar functions.

**Bausch and Lomb India Pvt. Ltd. (2016) 381 ITR 227 (Del) ,Sony Ericsson Mobile Communications India Pvt. Ltd (2015) 374 ITR 118 (Del)*

Facts

- The taxpayer is part of Luxottica group which designs, manufactures and distributes sun glasses and prescription frames, and is primarily engaged in purchase and resale of sun glasses, etc. The taxpayer is an Indian entity engaged in distribution of sun glasses etc.

AY 2010-11 and AY 2011-12

- In the afore-mentioned years, the TPO had applied the bright line test and had treated excess AMP expenses as separate international transaction, leading to development of brand owned by associated enterprises (AEs), for which the taxpayer had not been remunerated by its AEs.
- Aggrieved by the above adjustments, the taxpayer filed objections before the Dispute Resolution Panel (DRP). The DRP largely approved the adjustment proposed by the TPO for both the impugned AYs.
- Both taxpayer and the tax department filed appeals before the ITAT for the assessment years.

AY 2012-13

- With respect adjustment of AY 2012-13, the TPO deviated from the previous year's approach and instead of treating excess AMP spend as separate international transaction, the TPO considered it as a function to be carried out by a distributor.
- In doing so, TPO noticed that the comparables selected by the taxpayer and accepted by the TPO had very low or negligible marketing function. Instead of initiating a fresh search for comparables having similar intensity of marketing function, the TPO attempted to make comparability adjustment on the companies selected by the taxpayer and accepted by him. For this the TPO used the following approach:-
 - Taxpayer's selling, marketing and promotion expense were determined as percentage of sales - intensity of expenses incurred by the taxpayer
 - Companies which were comparable with the taxpayer were identified
 - Selling, marketing and promotion expenses as percentage of sales of such comparable companies were determined - intensity of expenses incurred by comparable companies
 - The intensity of expenses of taxpayer was compared with the intensity of expenses of comparable
 - The excess intensity of expenses in taxpayer's expenses as compared to the intensity of comparables was considered as excessive AMP expenditure considered by the taxpayer.
 - This excess AMP cost was then multiplied by a constant factor (presumably an arm's length margin). Subsequently, the excess cost and the corresponding revenue (i.e. the excess cost including the constant factor) was added respectively to the cost and revenue of the comparables and a revised return on sales (i.e. Operating Profit/ Operating Revenue (OP/OR)) was computed.
- Based on the above approach the average OP/ OR margin of the comparables was worked out to 6.03%. Since the margin earned by the taxpayer was 2.12%, which was outside the +/-5% range, the TPO made an adjustment on account of the same.
- The above adjustment was made on a proportionate basis and the same was restricted to the value of the international transaction pertaining to purchase of finished goods. For computing the proportionate adjustment, the TPO considered the international transaction of purchase of finished goods as a proportion of total finished goods purchased (including third party purchases), instead of the total operating cost of the taxpayer. The resultant adjustment was then subsumed in the transaction pertaining to purchase of finished goods.
- Aggrieved by the above addition, and also by the fact that the TPO applied TNMM instead of resale price method (RPM) for determination of arm's length margin, the taxpayer filed objections before the DRP. The DRP however did not interfere with the adjustment proposed by the TPO.
- Accordingly, the taxpayer filed an appeal before the ITAT.

Issue before the Tribunal

AY 2010-11 and AY 2011-12

- Whether incurring excess AMP expenditure constitutes an international transaction.

AY 2012-13

- Whether adjustment account of differences in intensity of marketing function was valid.*
- Whether RPM was the most appropriate method for distribution activity.
- Whether the TPO was justified in considering cost of Total Finished Goods purchased as the relevant base for proportionate adjustment.

* Even though the taxpayer had not argued on this issue, nevertheless the Tribunal has given its finding on the same.

Observations and Ruling of the Tribunal

AY 2010-11 and AY 2011-12

The ITAT followed the order of the Hon'ble High Court in the matter of Sony Ericsson and the taxpayer's own case for the previous year, and remanded the matter back to the file of the TPO/ Assessing Officer for deciding the issue afresh.

AY 2012-13

With respect to the issue of selection of most appropriate method, the ITAT concluded that RPM was indeed the most appropriate method given the nature of activity undertaken by the taxpayer and the fact that in the previous year the Hon'ble High Court had accepted RPM as the most appropriate in taxpayer's own case.

However, given the fact that the TPO made an adjustment on account of intensity of marketing function instead of treating the excess AMP cost as a separate international transaction. Also, given the fact that this adjustment was subsumed in the international transaction of purchase of finished goods. The ITAT has directed the TPO to examine the applicability of such an adjustment while applying RPM and in case the same cannot be made, then he may apply any other appropriate method for determination of arm's length margin.

With respect to application of an appropriate base for computation of proportionate adjustment the ITAT has given a finding that since the impugned international transaction is that of purchase of finished goods, it would be appropriate to consider the total cost of finished goods purchased and the appropriate base for determining the proportionate adjustment.

Conclusion

This ruling is distinct from other rulings on the issue of AMP as in the present case the TPO has attempted to shift from its previous approach of treating excess AMP expense as a separate international transaction. Instead, the TPO has classified marketing activity as a function undertaken by a distributor. However, since the intensity of the marketing function was higher than those of the comparables, the TPO has attempted to make an economic adjustment on the margins of the comparables to account for differences in intensity of marketing function.

From a transfer pricing perspective, the quality of comparables need to be scrutinized so as to choose those with close functional similarity to that of the taxpayer. No amount of economic adjustment can convert a non-comparable company into a comparable one - attempted in the present case by first selecting companies with low or no marketing activity and subsequently undertaking economic adjustment to make them functionally comparable.

Another aspect is that such intensity adjustments don't consider differences in marketing strategies adopted by companies. For example companies having low or no marketing expenses may use their own workforce for marketing activities instead of outsourcing, thus leading to low or no marketing expense but very high employee expense.

Also, the approach adopted by the TPO for computing proportionate adjustment seems inappropriate as it does not consider that the net margin earned by the taxpayer, is impacted by all expenses incurred by the taxpayer (i.e. both Cost of Finished Goods and Other Operating Expenses) and not just Cost of Finished Goods, as considered by the TPO. Accordingly, for computing the proportionate adjustment, it is important to consider not just the Cost of Purchase of Finished Goods but the entire operating cost as the appropriate cost base.

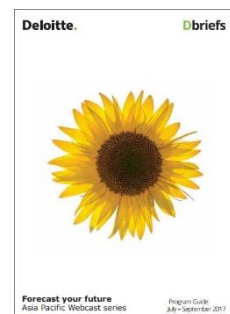
Source: Luxottica India Eyewear Pvt. Ltd. vs ACIT Cir-15(2), New Delhi (ITA No. 1492/ 2015, ITA 1205/2016 and ITA 344/2017) and ACIT Cir 15(2) vs Luxottica India Eyewear Pvt. Ltd. (ITA No. 1117/2015)

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