



Transfer Pricing Insight with information

AMP activity not an
international transaction
in case of
manufacturers

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Executive Summary

The Hon'ble Delhi High Court (HC) recently pronounced its ruling in the case of Maruti Suzuki India Limited (MSIL), involved in manufacturing, selling and distribution of cars, with respect to the transfer pricing (TP) adjustment on account of advertisement, marketing and sales promotion (AMP) expenditure incurred by it. The tax authorities had made TP adjustment by alleging that the excess AMP expenditure incurred by MSIL vis-à-vis the comparable companies had created marketing intangible for its associated enterprise (AE) Suzuki Motors Corporation (SMC) for which it should have received arm's length compensation from SMC.

The HC held that the alleged excess AMP expenditure incurred by MSIL cannot be regarded as an international transaction in the absence of any agreement or arrangement between the company and its AE. The HC also held that the AMP expenditure incurred by MSIL benefited MSIL itself in terms of its increased market share in India and year on year growth of its turnover. The HC further held that the quantitative approach adopted by the tax authorities for determining the existence of an international transaction based on excess AMP expenditure was not in accordance with the Indian transfer pricing regulations. Any benefit received by SMC is only incidental. Further, the extent to which AMP spent of MSIL has given rise to the benefit of "Suzuki" brand is a complex exercise and cannot be ascertained in the absence of clear guidelines by the statute.

Facts

- MSIL is engaged in the manufacture of passenger cars in India. It commenced its operations in 1982 as a Government of India-owned enterprise. Subsequently, it selected SMC as its business partner and became a subsidiary of SMC. MSIL entered into a license agreement with SMC for using co-branded trade mark "Maruti Suzuki" on its cars.
- In the transfer pricing proceedings, the Transfer Pricing Officer (TPO) issued a show-cause notice to MSIL for making TP adjustment on account of alleged excess AMP expenses incurred by the company. MSIL filed a writ petition for stay of TP proceedings before the HC challenging the notice issued by the TPO for making TP adjustment. The

HC passed an interim order that the TPO proceedings may go on but the final order of the TPO could not be given effect to.

- Consequently, the TPO passed its order making TP adjustment on account of AMP expenditure wherein the TPO concluded that :
 - The trademark “Suzuki” had piggybacked on the trademark “Maruti” without any compensation being paid SMC to MSIL
 - The trademark “Maruti” had acquired the status of “super brand” whereas the trademark “Suzuki” was a relatively weak brand.
 - Co-branding of “Maruti Suzuki” had resulted in the promotion of the trademark of the AE and reinforcement of the trademark “Suzuki” which was a relatively weak brand in India. This had also resulted in the impairment of the value of the “Maruti” trademark due to co-branding process.
 - Accordingly, the TPO alleged that MSIL had incurred huge AMP expense of 1.87% of its turnover as compared to an average AMP expense of 0.62% incurred by its comparables, viz. Hindustan Motors, Tata Motors and Mahindra and Mahindra. Therefore, by applying the Bright line test (BLT), the TPO held that the excess AMP spent incurred by MSIL was for promoting “Suzuki” brand of SMC and hence benefitted SMC. Accordingly, the TPO made TP adjustment for excess AMP spent that should have been recovered by MSIL from SMC.
- As the TPO passed the order during the pendency of the writ petition before the HC, the writ petition was amended to challenge the order of the TPO.
- The HC in the writ petition passed an order in July 2010, holding that co-branding of “Maruti Suzuki” evidences that Suzuki wanted to popularize its name in India at the cost of “Maruti” brand. It could not be accepted that Suzuki did not benefit from the compulsory use of Joint trademark. Since the TPO may not be able to determine the monetary value of the benefit obtained by Suzuki in the form of marketing intangible, the TPO would have to determine the ALP by finding out the amount of compensation that would have been paid in similar uncontrolled situations. However, the HC held that the procedure followed by the TPO in this case was arbitrary and faulty and directed the TPO to re-determine the appropriate ALP for the AMP incurred by MSIL.
- Subsequently, MSIL filed a writ petition before the Supreme Court (SC) wherein the SC directed the TPO to proceed with the matter without considering the HC order.

- Accordingly, the TPO passed its final order on December 21, 2010. The TP order was upheld by the Dispute Resolution Panel (DRP) and TP adjustment was finally included in the final assessment order (AO) of the Assessing Officer. Subsequently, the appeal was filed by MSIL before the Income tax appellate tribunal (ITAT).
- The TP adjustment on account of AMP expense was made by tax authorities in case of several taxpayers. Considering the importance of the issue, a Special Bench of ITAT was constituted in case of LG Electronics to adjudicate the issue of TP adjustment for excess AMP expenses. MSIL also filed an application as an intervener in the Special Bench proceedings.
- The Special Bench of ITAT in case of LG electronics specifically dealt with the case of MSIL and held that the direction given by SC to the TPO to determine ALP of AMP expenses inherently recognized the existence of an international transaction of brand building between MSIL and SMC. Consequently, the ITAT issued order in case of MSIL in accordance with the Special Bench decision in case of LG Electronics and made TP adjustment on account of excess AMP spent of the company.
- Subsequently, the appeal was filed by several companies (including MSIL) as well as by the tax authorities regarding the correctness of the LG case before the HC in case of Sony Ericsson (Sony Ruling). The HC, however, decided the case in Sony ruling only for those taxpayers which were engaged in distribution and marketing of imported branded products.
- Accordingly, the HC framed the substantial questions of law as given below in case of MSIL which is a manufacturer for TP adjustment on account of AMP activity.

Issues before the High Court

1. Whether the additions suggested on AMP expenses is beyond the jurisdiction of the TPO and bad in law as no specific reference was made by Assessing Officer (AO) to the TPO in respect of such transaction?
2. Whether AMP expenses incurred by taxpayer in India be treated as International transaction?

3. Whether TP adjustment can be made by TPO/AO in respect of AMP expenditure and if so in which circumstances?
4. If the answer to question 2 and 3 are in favour of revenue, whether the ITAT was right in holding that TP adjustment in respect of AMP expenses should be computed by applying cost plus method?
5. Whether the ITAT was right in directing the TPO to carry out fresh benchmarking analysis by applying the parameters specified in the Special bench ruling in case of LG Electronics?

Observations & Ruling of the High Court

- The HC observed that even though the HC had held in Sony Ericsson ruling that there exists an international transaction as far as AMP is concerned, such verdict did not apply to MSIL as its appeal was specifically de-linked by HC from such judgement.
- The Sony Ruling was passed only in case of distributors which distributes products manufactured by their foreign AEs and does not manufacture the products on their own. Further, the question of existence of international transaction was not disputed in Sony Ruling.
- In case of MSIL, the HC observed that the tax authorities could not prove the existence of any agreement or arrangement between MSIL and SMC regarding the AMP spent of MSIL. The tax authorities had used the BLT approach to deduce the existence of an international transaction on account of AMP. The tax authorities had contended that international transaction on account of AMP could be inferred as the AMP incurred by the taxpayers were significantly higher than the AMP incurred by the comparable entities. Since the BLT had been disregarded by Sony Ruling, there was no basis on which the tax authorities could conclude the existence of an international transaction on account of AMP.
- With respect to the benefit arising to SMC in strengthening its trademark “Suzuki” through the AMP expenses of MSIL, the HC held that MSIL had already built a huge reputation before SMC had acquired a controlling stake in MSIL in 2002 and substantial AMP expense had already been incurred by MSIL by that time. MSIL has the highest market share in India and achieved an approximately 21% growth of its turnover, year on year.

This was substantiated the fact that MSIL had been enjoying the benefit of the AMP expenditure incurred by it over the period.

- The HC also acknowledged the fact that SMC incurred AMP expense of around 7.5 % of its worldwide turnover while MSIL incurred only 1.87% of the turnover. This was further substantiated the fact that there was no arrangement or agreement between MSIL and SMC, whereby MSIL was obliged to incur AMP expenses on behalf of SMC.
- Accordingly, the HC held that since the tax authorities contested the existence of international transaction only on account of quantum of AMP, the HC overruled the existence of any international transaction with respect to AMP expenditure incurred by MSIL.
- Further, with respect to revenue's contention that the HC in its earlier ruling in the writ petition had already held that there existed an international transaction in case of MSIL on account of AMP expenses, the HC observed that the SC direction to the TPO to carry out the TP proceedings as per the law without being influenced by the order of the HC in the writ petition, had virtually nullified the order of the HC. Accordingly, the conclusion of the earlier order of the HC in writ petition cannot be relied upon for the existence of international transaction on account of AMP in case of MSIL.
- The HC also analysed the provisions of TP regulations and concluded that there had to be an international transactions with a certain disclosed price. On the other hand, the revenue first determined the bright line and then deduced the existence of international transaction based on the excess of AMP expense incurred by MSIL vis-à-vis the bright line. The HC disapproved such approach and held that the very existence of international transaction cannot be a matter of inference or surmise. The existence of international transactions has to be established, *do hors* BLT.
- With respect to economic ownership, the court observed and acknowledged that the co-brand mark "Maruti Suzuki" could not be used by SMC either in India or in any other country. Therefore, the basic condition for TP adjustment on AMP that foreign AE should be the legal owner of the trademark does not exist.
- The HC also held that if any AE receives any incidental benefit for being part of larger concern, it cannot automatically be inferred that such AE receives any group service.
- In the end the HC also acknowledged that the operating margin of MSIL was much higher than the average operating margin of the comparables. Accordingly, there is no question of any TP adjustment on account of AMP.

Conclusion

This is a landmark ruling of the HC providing major relief to the Indian manufacturers from the TP adjustment on account of AMP expenditure incurred by them. Though the Delhi HC has jurisdiction over the state of Delhi, given that the order was detailed, it will have a persuasive value for other HCs also.

The judgement rightly held that mere incurring of excess AMP expense cannot be inferred to have given rise to international transaction by creating market intangible for AE.

Manufacturing entities generally operate as entrepreneurs which are involved in complex operations of manufacture and sale. As long as the international transaction entered into by them are in line with transfer price, the AMP expenditure incurred by them cannot be inferred to have benefitted the AEs. Such entities are the economic owners of the brand and trademark and garner the benefit of their AMP activities through their increased turnover.

This ruling settles a major TP controversy in India on AMP expenditure and provides a more pragmatic roadmap to transfer pricing of international transactions of a manufacturers. This approach is in line with the business needs and realities.

Source : Maruti Suzuki India Limited vs CIT, Delhi High Court, ITA No. 110/ 2014 and ITA No. 710/ 2015; dated 11 December, 2015

Contacts

Ahmedabad

Heritage, 3rd Floor,
Near Gujarat Vidyapith,
Off Ashram Road,
Ahmedabad – 380 014.
Tel: + 91 (079) 2758 2542
Fax: + 91 (079) 2758 2551

Coimbatore

Shanmugha Manram
41, Race Course,
Coimbatore
Tamil Nadu - 641018
Tel: + 91 (0422) 439 2801
Fax: +91 (0422) 222 3615

Kolkata

Bengal Intelligent Park Building Alpha,
1st floor, Block EP and GP Sector V,
Salt Lake Electronics Complex,
Kolkata - 700 091.
Tel : + 91 (033) 6612 1000
Fax : + 91 (033) 6612 1001

Bangalore

Deloitte Centre, Anchorage II,
100/2, Richmond Road,
Bangalore 560 025.
Tel: +91 (080) 6627 6000
Fax: +91 (080) 6627 6010

Delhi/Gurgaon

Building 10,
Tower B, 7th Floor,
DLF Cyber City,
Gurgaon 122 002
Tel : +91 (0124) 679 2000
Fax : + 91 (0124) 679 2012

Mumbai

Indiabulls Finance Centre,
Tower 3, 28th Floor,
Elphinstone Mill Compound,
Senapati Bapat Marg, Elphinstone (W),
Mumbai – 400013
Tel: + 91 (022) 6185 4000
Fax: + 91 (022) 6185 4101

Chennai

No.52, Venkatanarayana Road,
7th Floor, ASV N Ramana Tower,
T-Nagar,
Chennai 600 017.
Tel: +91 (044) 6688 5000
Fax: +91 (044) 6688 5050

Hyderabad

1-8-384 and 385, 3rd Floor,
Gowra Grand S.P.Road,
Begumpet,
Secunderabad – 500 003.
Tel: +91 (040) 6603 2600
Fax: +91 (040) 6603 2714

Pune

106, B-Wing, 7th Floor,
ICC Trade Tower,
Senapati Bapat Road,
Pune – 411 016.
Tel: + 91 (020) 6624 4600
Fax: +91 (020) 6624 4605

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