



Global Tax Update

India

Deloitte Tohmatsu Tax Co.

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High Court overrules bright line test for AMP expenses

(1) Executive Summary

The Hon'ble Delhi High Court (HC) recently pronounced its ruling on transfer pricing (TP) adjustment on account of advertisement, marketing and sales promotion (AMP) expenditure incurred by them as part of their distribution business in India in the case of various Indian distributors (taxpayers¹).

The HC, while upholding that AMP expenditure could be considered as an international transaction, held that increased AMP expenditure does not presuppose contribution to brand building by the Indian entity for its overseas Associated Enterprise (AE). The HC held that brand value is created by synergetic impact of reputation, quality and other facts relevant to a particular business and not just by incurring AMP expense. Accordingly, the HC rejected the application of Bright line test for determining non-routine AMP expense and TP adjustment on account of separate consideration for such alleged non routine AMP expense incurred by the taxpayers.

1 Canon India Pvt Ltd (Canon India), Reebok India Company (Reebok India), Sony Ericsson Mobile communications India Pvt. Ltd (Sony), Discovery Communications India, Daikin Air-conditioning India Pvt. Ltd, Haier Appliances (India) P Ltd and Casio India Co. P. Ltd.

(2) Facts

- The taxpayers are Indian subsidiaries of multinational enterprises (MNEs) which are engaged in importing, marketing and distribution of branded products manufactured by its AEs wherein the intangible rights in the brand name are owned by AEs.
- The taxpayers substantiate the arm's length nature of their transaction with AEs relating to import of goods for resale in India using TNMM² in some cases and RPM³ in another; CUP⁴ method was used in one case to benchmark the royalty payment.
- The Transfer Pricing Officer (TPO) in all the above cases, in line with the Special Bench (SB) ruling in case of LG Electronics India⁵, applied the 'Bright line test' to determine the excess/ non- routine AMP expenditure incurred by the taxpayer for building brand for its AEs in India.
- The TPO held that the taxpayer should be separately remunerated for building brand by the taxpayer in India for its AEs at cost plus

2 TNMM- Transactional Net Marginal method

3 RPM- Resale Price Method

4 CUP- comparable uncontrolled Price Method

5 LG Electronics India Pvt Ltd vs Asst CIT (2013) 152 TTJ 273 (Del)

mark- up basis and proposed a Transfer Pricing adjustment to the taxable income of the taxpayers.

- The Dispute Resolution Panel (DRP) upheld the order of the TPO.
- The Income Tax Appellate Tribunal (ITAT) provided limited relief to the taxpayers in line with the SB ruling in the LG case, and held exclusion of direct selling costs like discounts and sale related expenses from forming part of AMP costs for application of the bright line test.
- Additionally, in one case, the TPO rejected the payment of royalty by the company to its AEs on the ground that the payment of royalty did not contribute to the profitability of the company. The DRP confirmed the order of the TPO but the Tribunal allowed the payment of royalty on the ground that the company had received know how and technical information from its AEs and hence it was a bonafide expenditure incurred by the company.
- Aggrieved by the ITAT order, both the Revenue and taxpayers have filed appeals before the HC to decide on the substantial questions of Law as given below.

(3) Issues before the High Court

- Whether the additions suggested on AMP expenses is beyond the jurisdiction of the TPO since no specific reference was made by Assessing Officer (AO) to the TPO in respect of such transaction?
- Whether AMP expenses incurred by taxpayer in India be treated as international transaction?
- Whether TP adjustment can be made by TPO/AO in respect AMP expenditure by applying bright line test and alleging that the incurring of non-routine AMP expenditure results in brand building by the taxpayer in India for its AEs?
- Whether ITAT was right in distinguishing and

directing that selling expenses in nature of trade/volume discounts, rebates etc. cannot be included as part of AMP expenses?

- Whether the TPO was right in deleting TP adjustment on payment of Royalty by one of the taxpayers to its AEs?

(4) Observations & Ruling of the High Court

1) Jurisdiction of the TPO

The HC held that after the retrospective introduction of section 92CA(2B) of the Act w.e.f. 1st June 2002 by the Finance Act, 2012, the TPO has the power to determine the arm's length nature of a transaction (that he may come across during the assessment proceedings), even if such transaction has not specifically been referred by the AO to the TPO.

The HC further held that, once the taxpayer has reported its international transactions relating to distribution which included AMP expenses and the reference is made for the composite or bundled international transaction, no separate reference to the TPO is required.

2) AMP - an international transaction

The HC upheld the views of the SB in LG case and held that AMP expenditure would amount to an international transaction. The HC observed that when the taxpayers themselves advanced an argument that the declared price of international transactions included a remuneration for their AMP function, the argument challenging it as not an international transaction is incorrect.

The HC rejected the contention of the taxpayers that AMP expenses incurred by the taxpayer is not an international transaction as these expenses are third party expenses. The HC clarified that transfer pricing dispute in regard to AMP pertains to the arm's length determination/ adequacy of compensation to the Indian taxpayer by the AEs for performing AMP functions and incurring expenditure in this regard.

3) Bundled/ Inter-connected Transaction-

The HC observed that taxpayers could aggregate the controlled transactions if the transactions are closely linked and meet specified common portfolio or packaged parameters and as such cannot be evaluated adequately on separate basis.

The HC further held that once the TPO accepts TNMM as the most appropriate method for determining arm's length price of bundled transactions, then it is impermissible to separately determine the arm's length price of a particular expenditure like AMP, since, such expense is already factored in the net profit of the interlinked transactions.

4) Brand and Brand Building

The HC observed that brand building is an outcome of various factors and is largely associated with the reputation and quality of the product or service. In progressive business, brand value or goodwill will show progressive increase but in falling business it may veer. There are situations where brands are built without incurring any substantial AMP and vice versa. Therefore, brand building cannot be commensurate with the quantum of AMP expenditure.

Reputed brands undertake advertisement, marketing and promotional activities to increase sale volumes and earn larger profits rather than for creating brand value.

The HC observed that the overseas AEs engage Indian AE to carry on the marketing, distribution and selling activity in India to achieve the benefit of increased sales.

5) Bright Line Test⁶

The HC held that universal application of bright

⁶ Bright line test refers to the testing the AMP expenditure incurred by the taxpayer in proportion to its sales (AMP/sales) with the average AMP/sales of the comparables to determine the routine and non routine AMP expenses incurred by the taxpayer.

line test to segregate AMP into routine and non-routine AMP is unwarranted. Further, the HC also held that such application of bright line test and to apply cost plus method to determine ALP would amount to adding provisions to the statute and rules, which are non-existent. Such approach is not permissible, especially in the absence of any statutory recognition or any international practice in this regard.

6) Determination of arm's length price

- The HC observed that when the Indian entity carrying on distribution activity incurs AMP expenditure, the arm's length analysis is required to ascertain whether Indian entity has been adequately and properly compensated for incurring such expenditure.
- The HC further observed that such compensation can be in the form of lower purchase price or non/ reduced payment of royalty or by way of direct reimbursement to ensure adequate profits to Indian entity.
- The HC accentuated the importance of a systematic transfer pricing analysis for arriving at the arm's length price by selection of most appropriate methods and appropriate comparables in line with the functions, assets and risks of the tested party.
- Where the margin of the taxpayer is in line with comparables carrying similar functions of the taxpayer including AMP function, no separate TP adjustment is warranted.

7) Disregarding actual transaction

The HC observed that the tax authorities can disregard the actual transaction or substitute the same for another transaction only in two exceptional circumstances:

- Where the economic substance of the transaction differs from its form; or
- When the form and substance of the transaction is same but the arrangement made in relation to the transaction, when viewed in totality, differs from the arrangement that would have been entered

into between independent enterprises

The HC observed that in the present cases, the tax authorities wrongly invoked second exception to treat excess AMP as brand building exercise. Incurring substantial AMP expenditure is a normal business arrangement even in free market conditions where independent third party distributor presumes it to be beneficial for its business and he is sufficiently compensated.

8) Economic Ownership

Turning down the argument on valuing economic ownership of the brand, the HC held that the economic ownership arises only in case of long term contracts. Further, the valuation of such economic ownership is not done regularly but is done when it is transferred to third party or the rights are terminated. TP valuation would be mandated only at that point of time.

9) Application of Resale Price Method (RPM)

The HC held that where RPM is used as most appropriate method by a taxpayer for determining arm's length price of its international transactions relating to distribution, it would be wrong to assert that gross profit margin would not include AMP expenses. The HC observed that if on comparability analysis, gross profit earned by taxpayer is in line with the comparable margins earned by comparables carrying similar AMP function as that of the taxpayer, no further TP adjustment is warranted. In such cases, the gross profit margin includes the compensation for AMP expenses.

Routine or non- routine AMP expenses would not substantially affect the gross margin when the taxpayer and comparables undertake similar AMP functions.

10) Cost plus method for separate remuneration for AMP expenses

The HC held that once AMP expense has been included as part of bundled transaction, it cannot be separately benchmarked under Cost plus method.

11) Direct Marketing and selling expenses

The HC further upheld that marketing and selling expenses like trade/volume discounts are not directly related to brand building exercise and have direct nexus with the marketing and increased volume of sales. Thus the same would not form part of AMP expenditure.

12) Royalty Payment

The HC upheld the order of the Tribunal that the arm's length nature of royalty payment can not be determined on the basis of profitability or earning of the taxpayer once it is accepted that technical information know how has been received by the taxpayer.

(5) Conclusion

This is a landmark ruling of the HC providing substantial relief to the Indian distributor companies of MNEs. They have been facing significant TP adjustment on account of the alleged contribution to building brand in India for their MNE by incurring excessive AMP expenditure. 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 distributor. This approach is in line with the business needs and realities.

Source : M/s Sony India Limited, Reebok India Company Ltd, Canon India Pvt Ltd and various Others , Delhi High Court, ITA No. various; dated 16 March 2015

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