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Incurring more expenditure on AMP compared to comparable companies, cannot be inferred as an international transaction between the taxpayer and its foreign AE

Background

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Essilor India Pvt Ltd[1] (the taxpayer) held that in the absence of an arrangement and agreement between the taxpayer and its Associated Enterprise (AE) to incur advertisement, marketing and sales promotion (AMP) expenditure to promote brand value, incurrence of more expenditure on AMP compared to comparable companies, cannot be inferred as an international transaction between the taxpayer and its foreign AE. Therefore, the question of determination of the arm's length price (ALP) on such transaction does not arise.

Further, considering that the AMP expenditure was not included as part of the cost base for computing the Profit Level Indicator (PLI), the Tribunal directed the Assessing Officer (AO)/Transfer Pricing Officer (TPO) to include the same as part of the cost base for the purpose of determination of ALP.

Facts of the case

- The taxpayer is a wholly owned subsidiary of Essilor International SA, France (AE), engaged in the business of trading in finished, semi-finished ophthalmic lenses, optical meters and processing of semi-finished ophthalmic lenses. The AE charged the royalty for grant of a licence to use quoting technology on lenses (anti-glare and hard coating). The taxpayer purchases ophthalmic lenses from the AE and sells them after some processing.

- During the year, the taxpayer had international transactions in the nature of import of lenses, instruments, consumables, fixed assets, royalty, purchase returns, export of lenses, commission receipts, receipt of services (training, web ordering), cost sharing, reimbursements and other related transactions.

- For Assessment Year (AY) 2009-10 the taxpayer adopted the Transactional Net Margin Method (TNMM) as the most appropriate method with operating profit margin to turnover as the PLI. The taxpayer's PLI was computed at 13.45 per cent which was higher than the arithmetic mean of two comparables namely GKB Opticals Ltd. and Techtran Plylenses Ltd. of (3.31 per cent). Accordingly, it was claimed that the international transactions were at arm's length.

[1] Essilor India Pvt. Ltd. v. DCIT [IT(TP)A No. 29/Bang/2014 and IT(TP)A No. 227/Bang/2015]

- During the assessment proceedings, the TPO observed that the taxpayer incurred expenditure on account of sales promotion and advertisement to the tune of INR16,24,01,249, which is 14.2 per cent of the total revenue. The TPO noticed that in the case of comparable companies chosen by the taxpayer viz. GKB Opticals Ltd. and Techtran Polylenses Ltd., the average expenditure on those items worked out to only 3.3 per cent of the turnover.

- The TPO adopted 3.3 per cent of the turnover to bench mark the transaction of the AMP with the AE. The TPO had also worked out the operating margin on the total operating cost at 20.22 per cent after excluding additional expenditure incurred on AMP of INR8,86,67,743 from the total operating cost. The TPO also applied the mark-up on the AMP expenditure at 20.22 per cent and proposed a Transfer Pricing (TP) adjustment of INR10,65,96,361.

- Before the Dispute Resolution Panel (DRP), it was contended that:

  - In the absence of an agreement between the taxpayer and its AE, the question of promotion of a brand or sharing the advertisement expenditure does not arise.
  - It cannot be presumed that there is an international transaction within the meaning of Section 92B of the Income Tax Act, 1961 (the Act).
  - The burden of proof lies on the TPO to prove the existence of an international transaction and not on the taxpayer.

- The DRP had set aside the issue to the file of the TPO to examine the case in the light of the decision of the Special Bench of the Tribunal in the case of LG Electronics[2] and determine the cost of services provided and apply a margin on the same by applying the cost plus method.

Taxpayer's contentions

- The taxpayer contended before the Tribunal that, an international transactions cannot be presumed on incurring AMP expenditure in the absence of tangible material to show that the two parties *'acted in concert'*.

- The AMP expenditure was incurred by the taxpayer only to promote the sale of the product of the taxpayer.

Tax department's contention

- The tax department contested that the matter may be restored to the file of the TPO for fresh adjudication in the light of the law laid down by the Honourable Delhi High Court in the case of Sony Ericsson[3].

Tribunal's ruling

- The AMP expenses incurred by the taxpayer are only for increasing the sales of its products and no benefit accrued to its AE, and there is no international transaction on AMP expenditure as envisaged within the meaning of Section 92B of the Act.

- The Tribunal drawing references from the Sony Ericsson decision held that in the cases dealt by the Delhi High Court along with Sony Ericsson were distributors of products manufactured by the foreign AE and not manufacturers themselves.

- The Tribunal noted that the taxpayers' in Sony Ericsson did not appear to have questioned the very existence of an international transaction with the foreign AE.

- The Tribunal categorically observed that the taxpayer has throughout been contesting before all the authorities, the very existence of an international transaction on account of incurring

[2] LG Electronics India Pvt. Ltd. v. ACIT [2013] 140 ITD 41 (Del)(SB)

[3] Sony Ericsson Mobile Communication India (P) Ltd. v. CIT [2015] 374 ITR 118 (Del)

AMP expenditure between the taxpayer and its AE. Accordingly, the law laid down by the Delhi High Court in the Sony Ericsson ruling cannot be applied to the taxpayer.

- Drawing references from the Delhi High Court decisions in the case of Maruti Suzuki[4], Bausch & Lomb Eyecare[5], Yum Restaurants[6] and Honda Siel[7], the Tribunal held that no TP adjustment can be made by deducing from the difference between AMP expenditure incurred by the taxpayer and AMP expenditure of the comparable entity if there is no explicit arrangement between the taxpayer and its foreign AE.
- Further, in the absence of machinery provisions, to ascertain the price incurred by the taxpayer to promote the brand values of the products of the foreign entity, no TP adjustment can be made by invoking the provisions of Chapter X of the Act.
- Merely because the taxpayer incurred more expenditure on AMP compared to the expenditure incurred by comparable companies, it cannot be inferred that there existed an international transaction between the taxpayer and its foreign AE. Therefore, the question of determination of the ALP on such a transaction does not arise.
- Further, considering that the AMP expenditure was not included as part of the cost base for computing the PLI, the Tribunal directed the AO to include the same as part of the cost base for the purpose of determination of the ALP.

[4] Maruti Suzuki India Ltd v. CIT [2015] 282 CTR 1 (Del)
[5] Bausch & Lomb Eyecare (India) Pvt Ltd. v. ACIT [2016] 237 Taxman 24 (Del)
[6] Yum Restaurants (India) Pvt. Ltd v. ITO [2016] 380 ITR 637 (Del)
[7] Honda Siel Power Products Limited v. DCIT [2015] 64 taxmann.com 328 (Delhi)

Our comments

The ruling delivered by the Tribunal emphasises that in the absence of an explicit arrangement and action in concert between the taxpayer and its AEs, the TPO cannot infer the existence of an international transactions by way of rendering services of promoting the brand of the foreign AE. The fact that the benefit of such AMP expenditure accrues to the AE is not sufficient to infer the existence of an international transaction.

The onus is on the Revenue to demonstrate through some tangible material, the existence of an 'arrangement' or 'understanding' between the taxpayer and its AE that the taxpayer would incur AMP expense in order to develop marketing intangibles for the AE.

It is also important for the taxpayers to contest that AMP is not an international transaction provided there is no explicit agreement or arrangement to incur the same at the behest of the AE so as to be covered by the favourable decisions in Maruti Suzuki, Bausch & Lomb Eyecare, Yum Restaurants and Honda Siel.

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