



TAX FLASH NEWS

The Delhi High Court held that AMP expenses incurred by Maruti Suzuki India does not constitute an international transaction. It also held the use of a bright line approach inappropriate for determining the existence of an international transaction and for making an adjustment

Background

Recently, the Delhi High Court (High Court) in the case of Maruti Suzuki India Limited¹ (the taxpayer) held that the Advertisement, Marketing and Sales Promotion (AMP) expenditure incurred by the taxpayer cannot be treated and categorised as an international transaction under Section 92B of the Income-tax Act, 1961 (the Act). Based thereon, the High Court concludes that the Transfer Pricing Officer (TPO) cannot make a transfer pricing (TP) adjustment on account of the AMP expenditure in this case. Distinguishing the Sony Ericsson² High Court ruling as the one which looked at the AMP issue for assesseees that were only distributors and not manufacturers themselves, the High Court rejected the Revenue's contention that after the aforesaid Sony Ericsson ruling, the existence of an international transaction in the case of the taxpayer cannot be questioned. Relying on the Sony Ericsson ruling, the High Court noted that the use of a Bright Line Test (BLT) both for determining if there is an international transaction with respect to AMP expense, and for the determination of the Arm's Length Price (ALP) is inappropriate.

Earlier this year, the Delhi High Court in the case of Sony Ericsson³ had adjudicated on the issue of marketing intangibles for taxpayers engaged in marketing and distribution functions. However, there was still no clarity on the applicability of the bright line concept to licensed manufacturers. This ruling by the Delhi High Court provides the much needed clarity for taxpayers functioning as licensed manufacturers.

Facts of the case

The taxpayer is engaged in manufacturing of passenger cars in India. Suzuki Motor Corporation, Japan (SMC) is the holding company of the taxpayer. During the Assessment Year 2005-06, the TPO undertook an adjustment to the total income of the taxpayer on account of the AMP expenditure incurred by the company by application of the BLT. The contention of Revenue being that as the taxpayer is undertaking sale of products under the brand name 'Maruti-Suzuki', excess AMP expense incurred by the company vis-à-vis the comparables, is promoting the brand Suzuki which is legally owned by SMC.

The taxpayer initially filed a writ petition before the High Court questioning the jurisdiction of the TPO on the issue. The same was subsequently amended to challenge the arbitrary and irrational basis on which TP adjustments were made to the returned income. While the High Court in the order held the adjustment made by the TPO to be irrational and arbitrary, it also observed that the onus was upon the taxpayer to satisfy the

¹ Maruti Suzuki India Limited v. CIT (ITA 110/2014)

² Sony Ericsson Mobile Communications India Private Limited v. CIT (2015 374 ITR 118)

³ Sony Ericsson Mobile Communications India Private Limited v. CIT (2015 374 ITR 118)

TPO that AMP expense was at arm's length under the Indian TP regulations. The High Court set aside the matter for fresh assessment by the TPO with reference to the guidance provided in the ruling. Thereafter, the taxpayer challenged the order of the High Court by filing a special leave petition in the Supreme Court. In its order, the Supreme Court, remitted the matter back to the TPO, with liberty to proceed with the matter uninfluenced by the observations of the High Court. After the Supreme Court's order, the TPO proceeded to undertake an adjustment on account of AMP expense incurred by the taxpayer by application of a BLT. The TP adjustment was challenged by the taxpayer in the Tribunal. The taxpayer was also an intervener in the Special Bench proceedings in the case of LG Electronics⁴. Finally, post the order of Tribunal, the matter again came for adjudication at the High Court.

Issues before the High Court

The questions of law as framed before the High Court for adjudication have been mentioned below:

- (i) Whether the addition suggested by the TPO was bad in law in the absence of a specific reference by the AO having regard to the retrospective amendment under Section 92CA of the Act?
- (ii) Whether the AMP expense incurred by the assessee can be treated as an international transaction?
- (iii) Whether a transfer pricing adjustment can be made by the TPO in respect of an expenditure treated as an AMP expense and if so, in what circumstances?
- (iv) Whether the Income Tax Appellate Tribunal (Tribunal) was right in holding that the TP adjustment in respect of the AMP Expenses should be computed by applying Cost Plus Method?
- (v) Whether the Tribunal was right in directing that a fresh benchmarking/comparability analysis should be undertaken by the TPO by applying certain comparability parameters?

High Court's ruling

The High Court has pronounced a landmark ruling on the issue of marketing intangibles for licensed manufacturers. Earlier this year, the Delhi High Court in the case of Sony Ericsson had held that AMP expenses constituted an international transaction. Taking a contrary stand based on the specific facts of the taxpayer, the High Court held in the instant case that no part of the AMP expense incurred by the taxpayer constitutes an international transaction. Since the AMP expense was not held to be an international transaction, other questions around the adjustment on account of the AMP expense, application of the Cost Plus method, and direction of the Tribunal for fresh benchmarking were adjudicated in the favour of the taxpayer. The findings of the High Court have been discussed in detail below:

Bright line test is not permitted under the law

- In line with the findings in the case of Sony Ericsson, the High Court held that the BLT as applied by the Revenue authorities is not permissible under the Indian TP regulations.
- The High Court observed that in the Sony Ericsson ruling, the AMP expense was held to be an international transaction only with respect to specific facts of the relevant taxpayers, who were only distributing the products manufactured by foreign Associated Enterprises (AEs) and not manufacturing the products themselves. The High Court observed that none of the three taxpayers in that case appeared to have questioned the existence of an international transaction. The High Court held that the same rationale would not hold good in the facts of the taxpayer. AMP expense cannot constitute an international transaction merely by application of BLT, especially when the application of the BLT has been struck down by the High Court in the Sony Ericsson ruling.

⁴ LG Electronics India Private Limited (ITA No 5140/Del/2011)

Onus on the Revenue to demonstrate the existence of international transaction

- The High Court held that the onus to demonstrate that an AMP expense incurred by a taxpayer constitutes an international transaction would rest upon the Revenue authorities. The existence of an international transaction would have to be established by the Revenue authorities without application of BLT.
- A TP adjustment is not expected to be undertaken by deducting the AMP expenditure incurred by the assessee from the AMP expenditure incurred by the comparable companies. Neither the substantive, nor the machinery provisions of the Indian TP regulations permit undertaking an adjustment by the application of BLT, in the manner applied by the Revenue authorities.

Lack of statutory guidance on the approach

- The High Court held that even in a case where an AMP expense incurred by the assessee is held to an international transaction, there is no machinery provision under the TP regulations to enable the Revenue authorities to determine the compensation entitled to an Indian entity. The value of a brand may be impacted by a number of factors specific to the industry and using the current approach would provide arbitrary results.
- The High Court observed that a clear statutory guidance is required on the approach to be adopted for determination of compensation in such a scenario. The approach used by the Revenue and the submissions made by them proceed purely on the surmises and conjectures, without backing of any statutory provisions.

Benefit to the related party is only incidental in the subject case

- In relation to the contention of Revenue on SMC being benefitted from the AMP expense incurred by the taxpayer, the High Court has noted the relevant facts of the taxpayer in the ruling. In the subject case, based on an intercompany agreement, SMC had granted a permission to the taxpayer to use the co-brand 'Maruti-Suzuki'. The Suzuki brand was legally owned by SMC. However, neither did the co-brand belong to SMC nor did it had the right to use the co-brand in India or outside. The High Court noted that as SMC is not entitled to use the co-brand, the question of benefit does not arise.
- On the contention of Revenue regarding the benefit flowing to SMC in the form of increased royalty, sale of raw materials etc, the High Court held that the benefit of additional AMP spend flowing to SMC is merely based on a presumption of the Revenue authorities. The global AMP spend of the taxpayer is much less than the worldwide AMP spend of the Suzuki group. Further, the amount flowing to SMC in the form of royalty and import of raw material has been benchmarked separately. Thus, the question of a benefit arising as a result of AMP spend does not arise.

No adjustment warranted if transactions are held to be at an arm's length

- The High Court relied upon the observation in the Sony Ericsson ruling that if on application of the Transactional Net Margin Method (TNMM), an Indian entity has operating margins higher than that of the comparable companies, no separate adjustment of the account of AMP expense is warranted. Based on the same, the High Court observed that as in the subject case, the net operating margin of the taxpayer is higher vis-à-vis comparable companies, the question of a TP adjustment on AMP expense does not arise.

Erstwhile ruling in the case of Maruti Suzuki is not binding

- The Revenue authorities placed reliance on the erstwhile ruling of the High Court in the case of Maruti Suzuki to contend that the observations of the High Court in the erstwhile ruling should still be binding. However, the High Court held that the erstwhile ruling in the case of Maruti Suzuki is no longer binding in light of the observations of the Supreme Court in the same case.

The table below provides a comparative breakdown of the key issues dealt with by the High Court ruling in case of Maruti Suzuki and Sony Ericsson with a Special Bench ruling in the case of LG Electronics:

Issue	Maruti Suzuki ruling	Sony Ericsson ruling	LG Special Bench ruling
AMP expense constitutes an international transaction	AMP expense is not an international transaction as application of BLT is not permissible under TP regulations.	AMP expense is an international transaction as the marketing and distribution functions are performed towards a related party.	AMP expense is an international transaction.
Application of BLT/bifurcation of expenses into routine versus non-routine	Relying on the Sony Ericsson ruling, application of BLT rejected.	Application of BLT and concept of non-routine AMP expense rejected.	Bright line expense is a tool to bifurcate AMP expenses into routine and non-routine.
Transfer pricing approach	If payment of royalty and import of raw materials is tested separately, there is no additional benefit flowing by way of AMP expense.	AMP function is closely linked to and a part of the overall distribution activity, can be aggregated for TP analysis.	Purchase of goods and AMP expense are separate transactions and cannot be aggregated.
Set off permissible/aggregation of transactions	In consonance with Rule 10B of Income-tax Rules, 1962, no adjustment is warranted as the margins of the taxpayer is higher vis-à-vis the comparables by application of the TNMM	Distribution of goods and marketing are closely linked transactions. Hence, no adjustment is warranted if the taxpayer is remunerated adequately by higher margins on the distribution of goods.	The AMP function is to be separately compensated even if there is higher profitability in the distribution function.
Economic ownership on intangibles	Concept of economic ownership appreciated.	Concept of economic ownership appreciated.	Concept of economic ownership rejected.

Our comments

The High Court ruling provides important guidance on the issue of AMP for licensed manufacturers. The most important observation of the High Court goes back to the statutory framework of the TP law, wherein neither is AMP expense covered as a specific international transaction nor the use of the BLT. The High Court has also clearly laid down that Revenue bears the primary responsibility to demonstrate the existence of AMP expenditure as an international transaction *de hors* of the application of BLT. This is likely to impact the so far existing blanket approach of the Revenue to make AMP adjustments on a pure quantitative application of the BLT. This ratio held by the High Court would be helpful to all such taxpayers where the existence of an international transaction relating to the AMP expenditure was purely construed by the Revenue based on application of the BLT.

While this ruling seems specific to the fact pattern of the case, where the Revenue seemingly did not otherwise demonstrate the existence of an international transaction through any tacit understanding or an inter-company arrangement between the taxpayer and SMC, the principles so decided by the High Court are likely to be applicable to other licensed manufacturers with a similar fact pattern. In many cases, where licensed manufacturers operate as full-fledged risk bearing entrepreneurs, the existence of any arrangement or understanding with AEs regarding AMP expenditure is unlikely. In such cases, the High Court ruling is expected to be helpful for the taxpayer to contend that TP should not apply on the AMP expenditure.

In view of the High Court ruling, although the initial onus seems to be on the Revenue, it is also important for taxpayers to demonstrate as part of their intercompany arrangements, TP documentation and their day-to-day business conduct that there is no arrangement or tacit understanding with the AE and the decision pertaining to AMP has been independently taken for the benefit of the business.

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Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

Vadodara

iPlex India Private Limited
1st floor office space
No. 1004, Vadodara Hyper
Dr. V S Marg
Vadodara – 390007
Tel: 0265-2351085 / 2322607

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