Delhi High Court upheld the Revenue's stand of characterising AMP expense as an international transaction subject to transfer pricing. Overrules principles laid down in the AMP Special bench ruling by holding aggregation approach appropriate for remunerating AMP functions

18 March 2015

Recently, the Delhi High Court (High Court) in the case of Sony Ericsson Mobile Communication India Pvt. Ltd[1] and several other connected matters[2] upheld the tax department's jurisdiction to advertisement, marketing and sales promotion (AMP) expenditure as an international transaction subject to Transfer Pricing (TP). The High Court further held that various legal ratios accepted and applied by the Income-tax Appellate Tribunals (Tribunals) relying upon the Special Bench ruling in the case of LG Electronics[3] as erroneous and unacceptable. Among its several findings in the case, the High Court held that distribution and marketing are intertwined functions and can be analysed together as a bundled transaction. And that segregation of non-routine AMP expenditure using the bright line approach is not appropriate. In line with the findings of the Delhi Tribunal in the case of BMW India Private Limited[4] (BMW ruling), the High Court also held that separate remuneration for the AMP activities may not be required if such compensation is already provided by way of lower purchase price or reduced payment of royalty.

Background

In 2013, in the case of LG Electronics India Private Limited, the Delhi Special Bench of the Tribunal (SB) delivered a ruling on the vexed issue of marketing intangibles and held that TP adjustment in relation to AMP expenditure incurred by the taxpayer for creating or improving the marketing intangible for and on behalf of its foreign Associated Enterprise (AE) is permissible. The SB also held that the taxpayer's use of brand/logo of its foreign AE coupled with proportionately higher AMP spend indicated an oral or tacit understanding between the taxpayer and its foreign AEs of building and promoting the foreign brand. The same can be construed as provision of service by the taxpayer to its AE.

The order in the case of BMW followed, wherein the Delhi Tribunal distinguished the facts of that case from that of the SB ruling, observing that BMW India is a distributor and the SB Ruling was applicable for licensed manufacturers. The Tribunal held that no separate compensation is required for excessive AMP expenditure as the same has been received by way of the premium profits earned by the taxpayer at the gross level as well as the net level vis-à-vis comparable companies.

---

[1] Sony Ericsson Mobile Communication India Pvt. Ltd v. CIT (ITA No. 16/2014) – Taxsutra.com

[2] There were 17 connected matters related to several taxpayers, including appeals and cross-appeals filed by taxpayers and by the Revenue

[3] LG Electronics India Private Limited v. ACIT [2014] 52 taxmann.com 240 (Del)

[4] BMW India Private Limited v. ACIT [2014] 146 ITD 165 (Del)

Subsequently, Delhi Tribunal in the case of Casio India Company Ltd.[5] and in a number of other cases, followed the SB ruling even for a distributor. These conflicting decisions led to a need for greater clarity and guidance on the issue that incessantly impacted the industry at large.

Issues before the High Court[6]

- Whether the addition suggested by the Transfer Pricing Officer (TPO) was bad in law in the absence of specific reference by the AO having regard to the retrospective amendment under Section 92CA of the Act?
- Whether AMP expense incurred by the taxpayer can be treated as international transaction?
- Whether TP adjustment can be made by the TPO in respect of expenditure treated as AMP expense?
- Whether the Tribunal was right in holding that the TP adjustment in respect of AMP expenses should be computed by applying Cost Plus Method?
- Whether the Tribunal was right in directing that fresh bench marking/comparability analysis should be undertaken by the TPO by applying certain comparability parameters?
- Whether the Tribunal was right in distinguishing and directing that selling expenses in the nature of trade/volume discounts, rebates and commission paid to retailers/dealers, etc. cannot be included in the AMP expenses?

High Court's ruling

The High Court has pronounced a landmark ruling on the issue of marketing intangibles. Holding the first two questions in the favour of the tax department, the High Court upheld that AMP expense constitute an international transaction subject to TP. While the High Court upheld the tax department's jurisdiction to such transactions, it overturned various other aspects of the SB ruling holding the application of such ratios is erroneous and unacceptable. The High Court has discussed the issue of AMP expense and marketing intangibles in light of fundamental principles of economics and TP. The findings of the High Court have been discussed in detail below:

- ***Transfer Pricing Officer has jurisdiction over non-reported transactions***

  The High Court held that in light of the retrospective amendment introduced by Finance Act 2012[7], the TPO is empowered to adjudicate on the transactions which have not been reported by the taxpayer in the Form 3CEB. No specific reference by the Assessing Officer (AO) is required for the same.

- ***AMP expense constitutes an international transaction***

  The High Court rejected the claim of the taxpayers that AMP expense is not an international transaction. Differentiating the provision of Chapter X from Section 37(1) of the Income-tax Act, 1961 (the Act), the High Court observed that the tax department is not questioning the reasonableness of AMP expenses incurred by the taxpayer towards third parties in India. The issue at hand is adequacy of compensation received by the taxpayer for performance of marketing and distribution functions. By virtue of application of the TP provisions, the TPO seeks to determine an arm's length compensation for the marketing and distribution functions performed by the taxpayer towards related parties.

- ***Aggregation of transactions and application of Transactional Net Margin Method***

  The High Court held that distribution and marketing are intertwined and may be examined as bundled/inter-connected transactions. Clubbing of closely linked transactions, which includes continuous transactions is permissible under law. However, close linkage of transactions is a pre-condition for aggregation. For example, transaction for import of raw material for manufacturing may not be aggregated with distribution activity due to absence of the close linkage. The High Court held that it would be inappropriate to proceed with Arm's Length Price determination with a pre-conceived supposition that each transaction must be analysed separately. The High Court also observed that in case the tested party is engaged in single line of business, there is no prohibition in applying Transactional Net Margin Method (TNMM) on an entity wide basis.

---

[5] ACIT v. Casio India Company Ltd. (ITA No. 6135 & 5611/Del/2011)

[6] The High Court admitted another question of law specifically for one of the connected matters before the court (ITA 213/2014). The same pertains to the tax department's appeal against setting aside/deleting transfer pricing adjustment on payment of royalty to an AE. The same was answered by the High Court against the tax department and in favour of the taxpayer. However, the same is not discussed in detail in this flash news.

[7] Section 92CA (2B) inserted by the Finance Act, 2012 with retrospective effect from 1 June 2002, empowering the TPO to examine the arm's length pricing of such international transactions that were not reported by the taxpayer and comes to the TPO notice during the course of proceedings before him.

Further, the High Court objected to the manner of application of TNMM by the TPO and held that AMP expense cannot be segregated and benchmarked separately. The first step would be to undertake functional analysis and finalise comparables for application of TNMM after which, once net margins are compared, AMP expense is already factored in the analysis. Separately benchmarking AMP expense under such case would lead to incongruous results.

The High Court however also noted that when suitable comparables are not available and it is not possible to make suitable adjustments, it would be advisable to adopt and apply other methods.

- ***Segregating non-routine AMP expenses using bright line approach lacks acceptability***

  The High Court ruled that while applying the bright line test, the tax authorities have measured all the taxpayers by a similar yardstick without focusing on the facts of the case. In the SB ruling, AMP expense was classified into routine and non-routine expense, with the latter attributed towards brand building services. The High Court rejected the contention of tax department to bifurcate AMP expense into routine and non-routine for the purpose of application of the bright line test.

  The High Court ruled that value of a brand depends upon the nature and quality of goods and services sold or dealt with. Treating brand building as equivalent to or direct resultant of advertisement and sales promotion would be largely incorrect. Taxpayers do not undertake advertisement with a purpose to increase the value of brand but to increase sale and thereby earn higher profits.

  Focusing on the importance of functional profile and characterisation of entities, the High Court discussed that in case of a normal distributor, undertaking marketing and distribution functions, it should be examined whether the distributor has been adequately remunerated by way of lower purchase price, reduced payment of royalty or payment in some other form. This observation of the High court is in line with the findings of Delhi Tribunal in the case of BMW ruling, where it was held that in case a distributor has been provided additional gross margins by way of reduced purchase price of the goods, there is no need to make a separate payment for advertisement and marketing function. The High Court also observed that a low risk distributor, undertaking minimal marketing and distribution functions, would be entitled to lower but fixed profits and the issue of AMP expense would not be relevant for such a distributor.

- ***Section 92(3) of the Act does not prohibit set off in case of bundled transactions***

  The High Court held that Section 92(3) of the Act does not incorporate a bar or prohibit set-off or adjustments. The concept of set off has been internationally well accepted and the legislative intent of Section 92(3) of the Act is not to deny set off in case of closely linked transactions. While arriving at this conclusion, although the High Court has treated the Act as supreme, it has endowed due importance to international guidance (OECD TP Guidelines, UN TP Manual) which can be referred to as a valuable and convenient commentary on the subject.

- ***Economic ownership***

  The High Court has well appreciated the concept of economic ownership of intangibles, quite contrary to the SB ruling which said it exists only in a commercial sense. The High Court observed that economic ownership of marketing intangibles would arise due to advertisement and marketing functions performed by a taxpayer in the course of a long-term contract. The High Court also ruled that the need for a transfer pricing valuation to determine an exit charge would arise in case a long-term distribution-cum-marketing agreement is terminated which results in transfer of economic ownership.

- ***Guidance on application of Resale Price Method for AMP expense***

  The High Court has stressed upon the need to ensure similarity in the intensity of functions of a tested party vis-a-vis a comparable while applying the Resale Price Method (RPM). Cases where comparables perform similar functions (including AMP functions) would produce better comparability. In case there is a mismatch, RPM should not be adopted as the most appropriate method.

- ***Selling expenses to be excluded from AMP expense***

  The High Court has ruled that direct marketing and selling expenses have a direct connect with increasing volume of sales and should be excluded from constituents of AMP expense.

  The table below provides a comparative breakdown of the key issues dealt with by the SB ruling and the High Court on marketing intangibles:

Issue	SB ruling	High Court ruling
Whether AMP spend construes an international transaction?	AMP expense is an international transaction.	AMP expense is an international transaction as marketing and distribution function performed towards AE.
Whether bright line test is a tool/ method to bifurcate expense into routine versus non-routine?	Bright line expense is a tool to bifurcate AMP expenses into routine and non-routine.	Application of bright line test and concept of segregation of non-routine AMP expense lacks statutory backing.
Whether AMP expense is a brand building service?	Incurrence of non-routine AMP expense constitutes provision of brand building service to the AE.	Brand building as equivalent or substantial attribute of AMP would be largely incorrect.
Whether aggregation of transactions permissible?	Purchase of goods and AMP expense are separate transactions and cannot be aggregated.	AMP function can be looked as closely linked to and a part of overall marketing and distribution activity, hence can be aggregated.
Whether set off is permissible?	AMP function is to be separately compensated even if higher profitability is present in the distribution function.	Closely linked transactions set off should be permitted.
Whether economic ownership on intangibles is a reality and relevant for transfer pricing purpose?	Concept of economic ownership rejected.	Concept has given due cognizance.
Whether selling and distribution expense constitute AMP expense?	Selling and distribution expense not a part of AMP expenses.	Selling and distribution expense not a part of AMP expenses.

Our comments

The High Court has laid down a path breaking ruling on the issue of marketing intangibles in India. On important aspects, there has been a significant departure from several findings and ratios decided in the SB ruling. Till now, the dispute on this issue in India has largely been around interpretation of law rather than principles of TP. This ruling delves deep into fundamentals of TP and Economics and places substantial reliance on detailed international guidance already available in the OECD and the ATO guidelines. In a nutshell, the ruling has paved a way for resolution of the AMP dispute in a justifiable manner which is welcome news for the taxpayers.

While the High Court seems to have examined different business models for distributors (viz., normal distributor, low-risk distributor) and how the AMP issue needs to be dealt in such arrangements, the ruling does not provide much clarity on the AMP issues in case of manufacturing arrangements.

While accepting the principle of economic ownership and set-off in respect to closely linked transactions, the High Court has specifically mentioned that it is an internationally accepted practice. In the current transfer pricing scenario in India where internationally prevalent concepts such as Advance Pricing Agreement (APA), APA roll back provisions, concept of range and safe harbour rules have already been introduced, this ruling is another significant indicator of India's TP regime adapting to global best practices.

As a way forward, it would be important for the taxpayers to ensure that appropriate functional and economic analysis is captured in the TP documentation itself rather than adopting a short cut approach for compliance. The TP documentation should capture detailed functional analysis and characterisation of the taxpayer and provide for an appropriate TP policy for its related party transactions. As a proactive approach to attain upfront tax certainty on this complex issue, the option of APA should be evaluated by taxpayers.

www.kpmg.com/in

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 (Ist 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

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