Bombay High Court Rules on Allowability u/s 37(1) on Benefits Incidentally Accruing to the Foreign Principals

The base intent of this article is to deliberate upon the recently pronounced decision by the Hon'ble Bombay High Court ('Bombay HC') in the case of NGC Network[i] wherein the order of the Income Tax Appellate Tribunal ('ITAT' in short) was upheld. It was held that the advertisement expenditure incurred by the assessee to popularise the business of the channel run by the foreign principal is allowable as there is a direct nexus between the amount spent on advertising and publicity, and the assessee's revenue. The mere fact that the foreign principals also benefited does not entail right to deny deduction claimed by the assessee under Section 37(1). The transfer pricing perspective on this issue shall also be discussed briefly in the ensuing paragraphs of this article. Read on...

I. Background

By and large, the law has been fairly settled that expenditure which is incurred wholly and exclusively for the business purpose has to be allowed in entirety, notwithstanding the fact that some third party was also benefitted by such expenditure. However, the issue is long-winding and the views on the same, depending upon the facts and circumstances in different cases, may change.

(Contributed by Committee on International Taxation. Comments can be sent to citax@icai.in).

[i] *CIT vs. N.G.C. Network (India) P. Ltd.* [2014] 50 taxman 240 (Bombay)

The debate on allowability of deduction under Section 37(1) of the Income-tax Act, 1961(hereafter referred to as the 'Act') flares up when another party incidentally benefited by such expenditure is a foreign Associated Enterprise (in short 'AE'). On one hand, while the Revenue Authorities on such issues contends that Chapter X provisions of the Act (*i.e.*, transfer pricing provisions as applicable on 'international transaction'[ii] between AE's) shall have precedence over the general provisions governing the deductibility of expense if the incidental beneficiary is an AE, the Assessee on the other hand, contends the view that since the expenditure is incurred with a view of augmenting its own business and not with the intent of endorsing the foreign AE's business, disallowance cannot be justified.

a) Factual Matrix of the Case

- NGC Network (India) P. Ltd.(hereafter referred to as the Assessee), a company incorporated in India is engaged in the business of distribution of T.V. Channels popularly known as National Geographic and History Channel.
- NGC Network Asia LLC ("NGC Asia") which operates the National Geographic Channel and Fox International Channel (US) Inc.("Fox") which owns and operates the History Channel shall, collectively be referred to as the foreign principals hereafter.
- The Assessee paid the foreign principals a lumpsum amount by way of distribution fees.
- The Assessee, in turn, received subscription fees from its re-distributors *viz.* media distributors, cable networks *etc.*, who were in turn compensated by the consumers in the form of subscription fees paid to view the channel.
- The assessee also earned agency commission by entering into ad-sales agreement with the advertisers who wish to advertise 'on air' during the telecast of such channels.
- With an intent to increase the popularity of the programme, the assessee incurred advertising and publicity expenses of ₹6,21,31,262/- and claimed deduction under Section 37(1).
- The assessee filed the return of income for AY 2005-06 and filed Form 3CEB to report the international transactions with the Associated Enterprises, *i.e.,* the foreign principals. The Transfer Pricing Officer (in short 'TPO') accepted the transactions as reported in Form 3CEB to be at Arm's Length.
- The Assessing Officer (in short 'AO') restricted the allowable deduction of advertising and promotion expenses under Section 37(1) to 33.33% contending that such expenditure not only benefitted the assessee but also the foreign principals.
- Being aggrieved by the disallowance, the assessee preferred an appeal before the Commissioner Income Tax (Appeals) [CIT (A)] who decided the matter in favour of the assessee.
- Subsequently, the Revenue went in appeal before the Income Tax Appellate Tribunal (ITAT). In view of difference in opinion of the Accountant Member and the Judicial Member, the President of ITAT made reference to a Third member. The order of the CIT (A) was upheld by the ITAT.
- Aggrieved by the order of the ITAT, Revenue went in appeal before the High Court.

b) Arguments by the Tax Department

- Deduction u/s 37(1) is not permissible because:-
  - The benefit accruing to the foreign principals was not disclosed in Form 3CEB.
  - Despite of the benefit accruing to the foreign principals, no contribution was made from them towards the cost of advertisement, publicity *etc.*
- Revenue relied on the decision of Delhi High Court in the case of **Maruti Suzuki India Limited**[iii] while contending that the arm's length price has to be determined and relied where benefits are accruing to the foreign principals.
- Revenue also placed reliance on the decision of the Gujarat High Court in case of **Navsari Cotton and Silk Mills Ltd**[iv] contending that in order to qualify for deduction under Section 37(1), the expenses must not be unreasonable and out of proportion. Since the amount expended far exceeded the revenue, the same cannot be allowed as a deduction.

c) Arguments by the Assessee

- It was contended that the expression 'wholly and exclusively' used in Section 37(1) does not mean 'necessarily'. In this context, the Assessee's

[ii] The issue as to what constitutes an 'international transaction' is highly fact sensitive and subjective. For the sake of brevity, we are not deliberating into the aspect as to what constitutes a transaction or an international transaction in this article.

[iii] *Maruti Suzuki India Ltd. vs. ACIT, TPO*[2010] 192 Taxman 317 (Delhi)

[iv] *CIT vs. Navasari Cotton & Silk Mills Ltd.* [1982] 135 ITR 546 (Gujarat)

counsel relied on the decision of the Apex Court in case of **Sassoon J. David**[V] wherein it was held that merely because the foreign principal was benefited by advertising, promotion and publicity it will not prevent the respondent-assessee from claiming benefit of deduction under Section 37(1).

- Assessee also relied upon the decision of Supreme Court in case of **Maruti Suzuki India Ltd**[vi] wherein it was held that the compensation of Arm's Length Price decided by the TPO and the findings of the TPO are conclusive.

d) High Court Ruling

i. Non-disclosure of Principal as a beneficiary in 3CEB

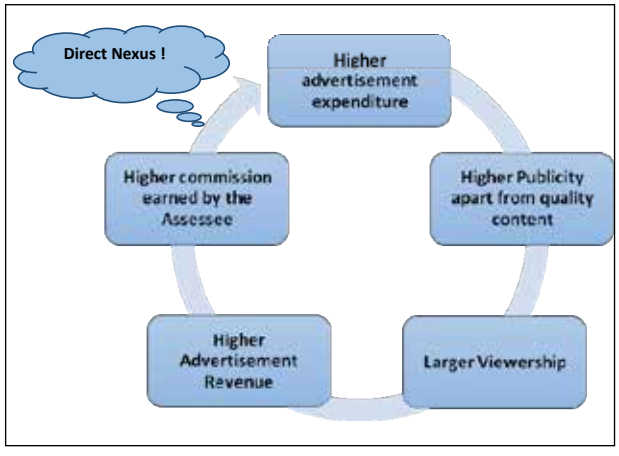
- The order of the TPO is final and the contention of department that no proper disclosure was made before the TPO cannot be accepted.
- Admittedly, the assessee being the agent of the foreign principal, the principal would naturally benefit from the advertisement carried out by its agent in India.
- The Contention of the assessee that extra territorial benefits derived by the Principal cannot be determined, is correct and justified.
- The assessee offered to tax its income from distribution and advertisement and therefore it is held that there is no suppression of any information.
- The TPO's view cannot be faulted with and restricting the deduction of total advertisement expenses to 33.33% cannot be justified.
- The advertisement expenses being made to the third party Indian residents were not reflected in Form 3CEB since only international transactions are covered under the gamut of Section 92 (governing the effect of Form 3CEB).

ii. Benefit of expenses not wholly derived by the assessee but also by the foreign Principal

- The Bombay HC primarily placed reliance on the Apex Court Judgment in Sassoon David (*supra*) wherein it was held that the mere fact that foreign principals also benefitted does not entail right to deny deduction under Section 37(1).
- The Revenue's contention that the assessee received fixed income cannot be justified since it received variable subscription fees as also commission of 15% of the value of Ad-sales.
- Bombay HC observed existence of a direct nexus between the amount spent on advertisement and publicity and revenue of the assessee.

iii. Expenses incurred far higher than the revenue earned

- Higher advertising expenditure through media houses and advertisement agencies would lead to higher chances of larger viewership. Higher viewership would entail chances of higher advertisement revenue and higher advertisement would in turn yield to higher commission being earned by the assessee.
- The Bombay HC held that there may be a lean period before revenue picks up notwithstanding high amount spent on such publicity and therefore the higher expenditure *vis-à-vis* the revenue is quite justified.



iv. No compensation by foreign Principals to avail the benefits of expenses incurred by the assessee

- The assessee (Indian Agent) earns income by way of distribution revenue and commission from ad-sales which sufficiently compensates it and it is not necessary for the foreign principal to compensate additionally for the

[V] *Sassoon J. David & Co. (P.) Ltd. vs. CIT* [1979] 118 ITR 261 (SC)
[vi] *Maruti Suzuki India Ltd vs. ACIT* [2011] 198 Taxman 102 (SC)

benefit derived by it from advertisement and promotion of its channels.

- The HC held that is not justified on the part of the Revenue to determine the sufficiency of compensation received by the assessee.

e) Key takeaways from the Judgment

On the basis of the decision of the Bombay HC and the consistent position followed in the judicial precedents including Apex Court judgment[vii] is that so long as the assessee derives direct benefit from the expenditure incurred by it, no adverse inference can be drawn notwithstanding, the incidental benefit enjoyed by another party (an AE in this case) even if the incidental beneficiary inures any direct or indirect benefit from such expenditure.

The transactions were outside the purview of Form 3CEB since the expenses were paid to Indian residents. In view of the above, the Bombay HC has rightly allowed the advertising expenditure under Section 37(1) of the Act, holding that the mere fact that the foreign principals of the assessee get benefitted does not entail right to deny deduction claimed by the assessee.

III. Interplay amongst Section 37(1) & Section 92

One important aspect which needs consideration while determining the allowability/deductibility of advertisement, marketing and publicity expenses is whether the expenditure is incurred by the assessee for promotion of its own business interest or for the business interest of the foreign principals. From Section 37(1) perspective, it is fairly a well settled position that an expenditure incurred wholly and exclusively for business purpose is to be allowed in entirety notwithstanding, the fact that some incidental beneficiary is also being benefited by incurrence of such expenditure.

However, what happens in a scenario where such expenditure is subject to transfer pricing provisions? Also, can provisions of Section 37(1) be read in isolation of the other provisions of the Act and which provisions shall take precedence-Section 37(1), Section 92 or both? Though some of the aspects have been considered in a few recent judicial pronouncements, yet no conclusive evidence can be drawn and the final word on the issue is still awaited.

The Division Bench of Delhi ITAT in the case of **Whirlpool of India Ltd.**[viii] while deliberating on the issue of TP adjustment towards AMP expenses incurred for the foreign AE has held that, after the TPO determines the expenditure for the benefit of AE, balance is deemed to be incurred for assessee's business and is automatically allowable under Section 37(1). The ITAT also held that the object of making TP adjustment is to segregate the total AMP expenses into amount spent by the assessee towards promoting the business of the assessee and amount spent towards promoting the business of foreign AE. While the former shall be allowed in entirety subject to the regular provisions of the Act, the latter would be added to the total income with suitable mark-up by way of a TP adjustment. Further, ITAT also held that disallowability of expenditure under both Section 37 and 92 would entail double addition to the extent of original amount spent for promoting the business of Foreign AE.

Recently the Delhi High Court in the case of **Cushman & Wakefield**[ix] deliberated on the issue that whether the tax authority/AO has jurisdiction to re-examine an intercompany transaction under Section 37 of the Act, even after it has been examined by the TPO for ALP determination. The jurisdiction of the Revenue Authorities to determine business exigencies under Section 37 of the Act is not overlapping with the jurisdiction of the TPO to

[vii] *Sassoon J. David & Co. (P.) Ltd. vs. CIT* [1979] 118 ITR 261 (SC); *CIT vs. Infosys Technologies Ltd.* [2014] 43 taxman 251 (Kar); *Novo Nordisk India (P.) Ltd. vs. DCIT* [2014] 42 Taxman 168 (Bang-Trib)
[viii] *Whirlpool of India Ltd. vs. DCIT* [2014] 42 taxman 553 (Del-Trib)
[ix] *CIT vs. Cushman & Wakefield (India) Pvt. Ltd.* (ITA 475/2012) dtd 23.05.14

determine the ALP of a particular expenditure. The decision as to whether the expenditure was "laid out or expended wholly and exclusively for the purposes of the business" is a fact determination or verification to be undertaken by the Revenue Authorities, and cannot be curtailed by a reference to the TPO under Section 92 of the Act.

IV. Marketing Intangibles

The above discussion would not be complete without mentioning the Transfer Pricing issue of 'Marketing Intangibles/AMP expenses'. The issue of marketing intangibles during past few years has become a bone of contention between the taxpayers and the TP Authorities.

Lately, the issue (incurring of AMP expenses and creation of Marketing Intangibles) has entered the realm of transfer pricing controversy. The contention of the Tax Department has been that since the Indian company incurs expenses which benefit the foreign AE, the Indian company should be reimbursed for such expenses. In fact, the proposition has been that by promoting the brand in India, the Indian subsidiary is providing a service to the foreign AE, for which it should receive due compensation (which could be the recovery of expenses incurred plus an appropriate mark-up over and above such expenses).

Judicial precedents in India have also not been able to provide a clear picture/way forward to resolve this issue. It is hoped that this issue will be more fully ventilated by the Courts in near future. The Delhi Bench of ITAT in **various cases**[x] placing reliance on the Special Bench ruling in the **LG Electronics case**[xi], held that benchmarking of AMP expenses, being an international transaction, is permissible under TP Regulations. Many of these matters have reached the Delhi High Court. The entire tax fraternity in India now awaits the decision of the Court so that clear guidance is available for both taxpayers and the Revenue Authorities, and the controversy, uncertainty and apprehensions on the 'hard to value intangibles' can be curtailed. ■

[x] *Sony India Pvt. Ltd. vs. ACIT* [TS-163-ITAT-2013(DEL)-TP], Canon India [TS-96-ITAT-2013(DEL)-TP], Discovery Communications *etc.*
[xi] *L.G. Electronics India (P.) Ltd. vs. ACIT* [2013] 29 taxman 300 (Del-Trib. SB)