Applicability of Transfer Pricing on Marketing Intangibles

In recent years, the Indian Revenue Authority (IRA) has been in continuous spotlight for taking aggressive positions in the audit proceedings, particularly with respect to Transfer Pricing (TP) matters. The key focus of the IRA has been on the most contentious issue of Advertisement Marketing and Sales Promotion (AMP) expenditure incurred by Indian affiliates of the Multinational Enterprises (MNEs), operating as a manufacturer and/or distributor. The Delhi High Court has recently delivered its decision on applicability of transfer pricing norms on marketing intangibles, bringing clarity on controversies surrounding the AMP expenditure and answered several vexed questions related to TP of marketing intangibles. The article discusses the ruling of the Court along with the background of the AMP issue and older judgements on the said issue for proper understanding of the readers.

1. Introduction

The IRA has been alleging that by incurring of "excessive" AMP expenditure compared to its comparables, the Indian affiliate have created a marketing intangible for its foreign parent/ associated enterprise (AE) which legally owns the brand and for which it was required to compensate the Indian affiliate for such brand building services along with an arm's length mark-up.

Manifestly, the said issue has been taken up aggressively by the IRA resulting in a large amount of TP adjustments in the hands of MNEs which adversely affected the investment sentiment in India. Having regard to the considerable importance of the issue, the Special Bench had been constituted in 2013 which had delivered its ruling, deciding the issue in favour of Revenue.

Being aggrieved by the Tribunal rulings which were on similar lines of the Special Bench rulings, a group of litigants/taxpayers, with a lead case being that of *Sony Ericsson Mobile Communications India Pvt. Ltd. [TS-96-High Court-2015(Delhi)-TP],* had

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filed an appeal before the Delhi High Court. The Delhi High Court pronounced the landmark verdict in March 2015 on the most vexed issue of AMP expenditure, setting up clear directions on principles on which adjustment could be made, which has been discussed in detail as under:

2. Ruling of the Delhi High Court

The Delhi High Court, in its landmark verdict, has addressed the controversies surrounding the TP adjustment on marketing intangible *i.e.*, AMP expenses, arising out of the ruling of the Special Bench in the case of *LG Electronics India Pvt. Ltd.* ('LG India'), and answered several vexed questions related to TP of Marketing Intangible. It is pertinent to note that even though LG India was not the subject matter of challenge before the High Court, the High Court in its ruling has extensively referred to the case to indicate points on which it concurs with the Special Bench and on which it disagrees.

Before discussing the ruling of the High Court, for reader's understanding, we have given below an overview of AMP issue along with a summary of the Special Bench ruling *i.e.*, the article has been divided as under:

1) *Background of AMP issue*
2) *Summary of Special Bench ruling*
3) *Overview of case before the High Court*
4) *Analysis of High Court ruling*

2.1. Background of AMP Issue

A. Corporate Tax Audit Proceedings

In the past, the IRA in the course of corporate tax audit proceedings while dealing with deductibility of 'marketing spend', had disallowed certain percentage of AMP expenses on the ground that a portion of such expenditure benefits the brand owner and hence, such portion does not relate to business of the Indian affiliates.

However, the above adjustment has been struck down by the courts in cases of Nestle India, Star India, Sony India and Adidas India Marketing on the ground that the expenses incurred by the taxpayers were solely for the benefit of its business and benefits derived by the foreign affiliates if any, were merely incidental and hence, such expenses are fully deductible.

It is pertinent to note that even though LG India was not the subject matter of challenge before the High Court, the High Court in its ruling has extensively referred to the case to indicate points on which it concurs with the Special Bench and on which it disagrees.

B. Transfer Pricing Audit Proceedings

This issue had been first considered by the IRA few years ago in TP assessment proceeding of some of the Indian affiliates of MNEs. The IRA had held that the AMP expenditures incurred by Indian affiliates are excessive and such excessive expenses results in creation/enhancement of marketing intangibles which are owned by foreign MNEs. In such cases, the IRA applying the Bright Line Test ('BLT') held that such excess AMP expenditure compared to comparable companies should be reimbursed to Indian affiliate by overseas AEs owning such intangibles. Further, the IRA had also applied an *ad hoc* percentage of mark-up (in the range of 10% - 12%) to such excess expenditure to be recovered from overseas AEs for rendering services.

The IRA had not considered/given due cognisance to the fact that the Indian affiliates have incurred AMP spend to boost up their sales and profit, and proceeded with their preconceived notion that such excess AMP expenditure results in creation/enhancement of marketing intangibles with respect to the brands legally owned by the MNEs. Pursuant to which the IRA had contended that non-routine marketing efforts of a subsidiary of the MNEs should be categorised as "service" rendered to their AE and accordingly, it should be compensated for the same along with an arm's length mark-up. This focus has intensified and has resulted in severe adjustments in case of several Indian affiliates of MNEs in recently concluded transfer pricing audit proceedings.

2.2. Summary of Special Bench Ruling

Considering the growing importance of the AMP issue in enormous taxpayers and to examine the sanctity of action of the IRA, a Special Bench of the Delhi Tribunal had been constituted in the case of LG India to examine the highly vexed issue pertaining to TP adjustment AMP expenditure.

The Special Bench, *vide* its order dated 23rd January, 2013, in a majority decision[1], largely ruled in favour of the IRA, a summary of key observations of the Special Bench is as under:

Issue	Key Observation of the Special Bench
Transaction And International Transaction	Given the fact that the Taxpayer promoted its products and brand owned by the foreign AE coupled with excessive AMP expenditure implied an agreement between the Taxpayer and its AE. Accordingly, in the case of the Taxpayer, incurring AMP expenses towards brand legally owned by the foreign AE constituted an 'international transaction' subject to TP provisions and was in the nature of provision of service.
Bundled Approach For Benchmarking Purpose	The Special Bench held that since the transactions of purchase of goods from foreign AE and provision of brand building services were not closely linked, the same could not be bundled for benchmarking purpose under the Transactional Net Margin Method (TNMM).
Bright Line Test (BLT)	The Special Bench held that BLT is not a method to determine arms' length price (ALP) but a mechanism to determine cost/value of transaction related to ALP. However, the Special Bench has rejected Transfer Pricing Officer's (TPO) choice of comparables for applying the BLT and further listed down various factors that need to be considered while determining the presence of a transaction and quantification of the same.
Expenses To Be Excluded From AMP	The Special Bench held that expenses incurred 'in connection with sales' do not lead to brand promotion and hence cannot be brought within the ambit of AMP expense.
Arm's Length Mark-Up To Be Charged	The Special Bench also upheld that since the transaction was in the nature of services and hence, mark-up needs to be applied on the same. However, it rejected mark-up considered by the Dispute Resolution Panel ('DRP') and directed the TPO to determine the quantum of mark-up based on the mark-up that would be charged by a third party for provision of similar services.

2.3. Overview of case before the High Court

Being aggrieved by the Tribunal rulings which were on similar lines of the Special Bench rulings, a group of litigants/taxpayers, with a lead case being that of *Sony Ericsson Mobile Communications India Pvt. Ltd.*, had filed an appeal before the Delhi High Court. Summarised below is a background of the case and question of law involved before the High Court:

A. Background of the case

- The litigants are engaged in import, distribution and marketing of products manufactured by their foreign AEs under their brands and further, the marketing intangible were owned and controlled by the foreign AE.
- The litigants had benchmarked their international transactions of import of finished goods for resale, by adopting TNMM with profit level indicator (PLI) of operating profit/total cost ratio, or resale price method (RPM) with PLI of gross profit/sales.
- The TPO considered that incurrence of substantial AMP expenses by the taxpayers, in relation to the marketing intangibles owned by the foreign AE, were in the nature

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1 The Special Bench ruling is the view of two out of the three members of the bench. The Judicial Member (JM), who did not concur with the majority view, has issued a dissenting order.

of services for creation or improvement of marketing intangibles and, therefore, the same have been for the benefit of respective foreign AEs. Thus, the TPO concluded that the taxpayers should have been compensated by the foreign AEs, at arm's length.

- The litigants have filed an appeal before the DRP as well as the Tribunals wherein the Tribunal have in principal followed the path of Special Bench and directed the TPO to give effect to the same.
- Aggrieved, the taxpayers as well as the Revenue filed appeals under Section 260A of the Income-tax Act, 1961 ("Act") before the High Court.

B. Question of law raised before the High Court

Following are the substantial questions of law raised by the litigants/Revenue before the High Court:

- Whether TPO had jurisdiction to examine the AMP expenses when no specific reference was made to him by the Assessing Officer ("AO").
- Whether AMP expenses can be treated and categorised as an international transaction under Section 92B of the Act.
- Whether TP adjustments can be made in respect of AMP expenses, and if so, under what circumstances.
- Whether the Tribunal was right in holding that TP adjustment in respect of AMP expenses should be computed by applying Cost Plus Method.
- Whether the Tribunal was right in directing that fresh benchmarking/comparability analysis should be undertaken by the TPO by applying parameters laid down in paragraph 17.4 of the Special Bench Ruling.
- Whether the Tribunal was right in distinguishing and directing that selling expenses, such as trade/volume discounts, rebates and commission, *etc.*, cannot be included in AMP expenses.

2.4. Analysis of High Court Ruling

The Delhi High Court, in its landmark ruling, has accepted as well as rejected various ratios applied by the Special Bench in the case of LG India. Following is a brief overview of the ruling along with detailed analysis:

In Brief

The High Court while holding that AMP spend may be considered an international transaction, has concluded that the compensation for AMP expenses may be included or subsumed in the purchase price of goods imported from AEs or a lower charge for royalty.

The High Court has held that the arm's length nature of the arrangement may be tested by way of an aggregate or bundled analysis with other transactions relating to the distribution activity. If the IRA seeks to unbundle the transactions, they should elucidate its reasons for doing so. The High Court emphasised that transfer pricing is an income allocating exercise and should not result in over or double taxation.

The High Court also rejected the application of the so called "Bright Line Test" advanced by the IRA for determining whether the taxpayer needs to be compensated for its promotional efforts.

The High Court has restored the matters back to the Appellate Tribunal for a final determination, taking into account the principles laid down by the Court.

In Detail

i. Jurisdiction of the Transfer Pricing Officer

The Transfer Pricing provisions, as existing at the time of scrutiny assessment of the captioned cases, allowed the TPO to determine ALP of a transaction referred to him by the AO only and thereby the TPO could not assume jurisdiction over a transaction not referred to him. However, the Finance Act 2012 amended the provision retrospectively (with effect from 1st June 2002) which gives power to the TPO to test any transaction that has not been reported in the TP certificate *i.e.,* Form 3CEB but comes to his notice during assessment proceedings.

Given that the transfer pricing orders of the captioned cases had been passed during 2010 *i.e.*,

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before the amendment, the taxpayer had argued that the amended provisions, albeit of retrospective effect, cannot be invoked to regularise the otherwise invalid action of the TPO.

Findings of the High Court

The High Court, in its ruling, held that after the retrospective amendment inserted in the Finance Act, 2012, the Special Bench was correct in stating that the TPO was empowered to examine the ALP of the international transaction which came to his notice during the course of audit proceedings and that were not reported or furnished by the assessee in Form 3CEB. The High Court also held that no specific reference was required to be made to the Assessing Officer for the same.

ii. AMP Expenses Treated As International Transaction

The taxpayers had contended that there was no understanding either oral or written, between the taxpayer and its AE for promotion of the brand owned by the latter and hence, in the absence of the same, there was no transaction of brand building services.

The tax authority on the other hand had been arguing that an oral arrangement is apparent from the facts that the taxpayer is the wholly owned subsidiary of its foreign parent and had incurred excessive AMP expenditure which would not have been incurred by a third party distributor in an uncontrolled scenario.

Findings of the High Court

The High Court, in its ruling, has accepted the ratio of the Special Bench and held that the expenditure of AMP will be treated as an International Transaction and also held that the AMP expenditure towards promotion of brand constituted a transaction of provision of services as per Section 92B of the Income-tax Act, 1961.

Further, the High Court, differentiating provisions of Chapter X from Section 37(1) of the Income-tax Act, has observed that the tax department is not questioning the quantum of expenditure rather they are questioning the adequacy of compensation with respect to the AMP expense incurred under the TP provisions *i.e.*, they seek to determine ALP of compensation for marketing and distribution function performed by an Indian affiliate of MNEs.

However, the High Court has also observed that in a case where a taxpayer is undertaking manufacturing, distribution and marketing, it may not be appropriate to combine and benchmark all three transactions together under TNMM. In such a scenario, the appropriate approach may be to benchmark manufacturing separately and distribution and marketing separately.

iii. Bundling of the Transaction And Application Of TNMM

The Taxpayer had argued that their operating margins were higher than those of comparables and while arriving at an operating margin of tested party, AMP expenditure has already been subsumed for. Accordingly, once the IRA had accepted the ALP of the reported international transactions, they cannot be allowed to segregate the AMP expenditure and benchmark the same separately. Further, the taxpayers had also contended that the higher profitability earned by them meant that their AE supplied goods at lower prices to compensate Indian affiliates for their efforts towards advertising and marketing.

The Special Bench held that each transaction has to be benchmarked separately unless two transactions are so closely linked that they cannot be separately benchmarked. The Special Bench further held that the transactions of purchase of goods from AE and provision of brand building services were not closely linked and hence, the same could not be benchmarked together using TNMM.

The Special Bench has further held the higher profitability earned by the taxpayer can be due to several different factors and it needs to be established with tangible evidence that the foreign parent sold goods to the taxpayer at a lower price to compensate for AMP expenses. The taxpayer cannot be allowed to reduce its real profits by including certain expenses which are for the benefit of foreign AE.

Findings of the High Court

a) Bundling of Transaction

The High Court held that as per Section 92C(1) of the Act, a class of transaction

can include a number of closely linked transactions and clubbing of such transactions for benchmarking purpose is permissible under the Indian TP regulations.

Since in the present case, distribution and marketing are intertwined and thereby may be examined as bundled/inter-connected transactions and thereby, no segregation is required for benchmarking purpose subject to the fact that functionally similar comparables are available. However, the High Court has also observed that in a case where a taxpayer is undertaking manufacturing, distribution and marketing, it may not be appropriate to combine and benchmark all three transactions together under TNMM. In such a scenario, the appropriate approach may be to benchmark manufacturing separately and distribution and marketing separately.

b) Application of TNMM

The High Court also acknowledged the fact if the IRA accepts and adopts TNMM as the most appropriate method and chooses to treat the AMP expenditure separately and not as a bundled transaction, it would lead to incorrect results due to the reason that while computing the margins under the TNMM, the treatment of AMP expenditure would already have been taken care of.

The High Court noted that under the TNMM analysis, once the comparables pass the functional analysis test and profit margin of the taxpayer is commensurate with that of arithmetic mean of comparables, it leads to an affirmation of the transfer price as the ALP and post which it is not permissible to make a comparison of a particular item of costs without segregation of profits as well. However, the High Court also noted that when suitable comparables are not available and/or it is not possible to make suitable adjustments, it would be advisable to adopt and apply other methods.

Manifestly, the High Court, relying on the OECD TP Guidelines, held that when a subsidiary engaged in distribution and marketing activities incurs AMP expenses, the compensation may be in the form of lower purchase price, no or reduction in royalty or by way of direct compensation to ensure an adequate profit margin.

The High Court also stated that the set off in the case of aggregation or bundling of transactions is well accepted by the OECD guidelines and UN Transfer Pricing Manual, if the transactions are closely interlinked.

iv. Brand Building

The IRA had been bifurcating AMP expenditure into routine and non-routine expenditure and considering non-routine expenditure to be towards brand building for the AE for which the taxpayer was required to be compensated.

Against which the taxpayers had argued that the AMP expenditure have been incurred to enhance sales of taxpayers only and thereby increase their profitability and not to improve the value of the brand and accordingly, they could not be asked to get compensation of the same from its AEs.

Findings of the High Court

The High Court ruled that value of a Brand reflects the reputation which the Brand owner has earned over a period of time and largely depends upon the nature and quality of goods and services sold or dealt with and thereby treating brand building as direct resultant of AMP expenditure would be largely incorrect. The High Court also acknowledged the fact the taxpayers do not undertake advertiseming with the purpose of increasing the value of the brand, but to increase their sales and thereby earn higher profits.

The High Court, giving credence to the taxpayer's argument that there was a benefit to the taxpayer from the increase in sales, provided substantial guidance in this landmark ruling on how the taxpayer and IRA should approach the issue on marketing intangibles.

v. Bright Line Test

The BLT concept had been espoused by the US Tax Court in the case of *DHL Inc. and Subsidiaries vs. Commissioner* (TCM 1998-461). Taking principles from the same, the IRA applied the BLT for determining the ALP of AMP expense, as the difference between AMP expenses to sales ratio of Taxpayer *vis-à-vis* AMP expenses to sales ratio of comparable companies.

The High Court held that for the purpose of mark-up, prime lending rate cannot be used under Rule 10B(1)(c) and that the mark-up has to be benchmarked with comparable uncontrolled transactions or transactions for providing similar services.

The taxpayer had contended that the BLT used by the IRA to determine the ALP of an international transaction was not one of the recognised methods under the Indian TP regulations and hence, need to be rejected.

The Special Bench has held that the IRA had not used BLT to determine the ALP of the transaction but used it to determine the value/cost of the transaction as the taxpayer had not provided any assistance in determining the value of the international transaction.

Findings of the High Court

The High Court, overturning the ruling of the Special Bench, rejected use of BLT as a way of identifying a cost/value of an international transaction. The High Court noted that it is difficult to compartmentalise promotion of product or promotion of brand expenses and record them as separate from each other.

The High Court held that direction of the Special Bench of applying BLT on basis of parameters prescribed in paragraphs 17.4 and 17.6 of its ruling tantamount to prescribing a mandatory procedure which has not been stipulated under the Act or Rules. Given the fact that there was nothing in the Act or Rules to that effect, the High Court noted that AMP could not be subject to BLT and thereby the IRA could not consider non-routine AMP expenditure as separate transaction.

Manifestly, the High Court, relying on the OECD TP Guidelines, held that when a subsidiary engaged in distribution and marketing activities incurs AMP expenses, the compensation may be in the form of lower purchase price, no or reduction in royalty or by way of direct compensation to ensure an adequate profit margin. Further, the High Court reiterated the observations of the Delhi tribunal in the case of *BMW India Pvt. Ltd.* wherein it has been held that net profit under the TNMM may be a sufficient proof of adequate compensation to the taxpayer from the AE.

vi. Concept of Economic Ownership

The Special Bench held that the Income Tax Law recognises only legal ownership of intangibles and economic ownership exists only in a commercial sense and further held that in the instance of sale of brand by the AE, the Taxpayer would not be entitled to a share in the total consideration towards sale of brand by virtue of it being an economic owner.

Findings of the High Court

The High Court, contrary to the Special Bench ruling, has well appreciated that economic ownership of brand and marketing intangibles is important factor for determining the pricing mechanism of distributors, having long term distribution licenses. The High Court also ruled that the need for TP valuation to determine an exit charge would arise upon termination of the distribution-cum-marketing agreement or upon transfer of economic ownership to a third party.

vii. Miscellaneous Issues

a) Scope of AMP Expense

The High Court uphold the Special Bench ruling that the selling expenses such as discounts, rebates and sales incentives are in the nature of direct selling expenses and are not incurred for the publicity and advertisement of the products sold and therefore, such expenses are not in the nature and character of 'brand promotion' and thereby would not form part of the AMP expenditure.

b) Resale Price Method

The High Court held that RPM can be applied as a most appropriate method if the functions performed by the tested party and the comparables are similar in nature. It was also observed that adjustment can be made while applying the RPM if the IRA finds that the taxpayer has incurred substantial AMP expenses in comparison to the comparables. It also held that in a scenario where it is not possible to make adjustments, then RPM may not be the most appropriate method.

c) **Mark-Up**
The High Court held that for the purpose of mark-up, prime lending rate cannot be used under Rule 10B(1)(c) and that the mark-up has to be benchmarked with comparable uncontrolled transactions or transactions for providing similar services.

d) **Order of Remand**
The High Court has remanded the matters back to the Tribunals for *de novo* consideration as the legal ratios applied by the Tribunal were erroneous and unacceptable in certain cases.

Further, the High Court directed the Tribunal to verify facts of the case and apply the legal ratios laid down in the decision. Also, directed the Tribunal to endeavour to dispose of the appeals rather than passing an order of remand to the lower level authorities.

3. Concluding Remarks

The Delhi High Court has pronounced a landmark ruling providing clarity on legal aspects related to Transfer Pricing treatment for Marketing Intangible and also laid down significant albeit broad principles of law to be applied to facts of each case. The High Court acknowledged the fact Transfer Pricing issue of marketing intangibles is highly factual which largely depends on the Function, Asset and Risk Analysis of each taxpayer and thereby common principles as laid down by the Special Bench cannot be applied universally to all taxpayers.

The key principles emanating from the High Court ruling is that a related party that makes contribution *i.e.*, incurs AMP expenses particularly to develop or enhance the value of intangible such as a trademark or a brand name owned by AE is entitled for arm's length compensation for such contribution. However, the High Court acknowledges the fact that such compensation may be in the form of lower purchase price, non or reduced payment of royalty or by way of direct payments to ensure adequate profit margin which will ensure proper payment of taxes and curtails avoidance or lower taxes of the Indian subsidiary.

The High Court, by stressing on the comparability aspect, has affirmed the fundamental principle that the distributor's share of benefits should be determined based on what an independent distributor would receive in comparable circumstances as in a number of situations the distributor's efforts may be enhancing the value of its own intangibles, namely its distribution rights.

The High Court has clarified that TP regulation is an anti-avoidance regulation and thereby the IRA should take care that it must not end up in 'double taxation'.

The High Court has clarified that TP regulation is an anti-avoidance regulation and thereby the IRA should take care that it must not end up in 'double taxation'. The High Court while acknowledging the fact that the Act and Rules are supreme, reliance can be placed on international guidance *i.e.*, OECD TP Guidelines, UN TP Manual and the ATO guidelines.

Also worthwhile to note that the High Court in this ruling have examined different business models for distributors 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.

The Delhi High Court ruling clearly demonstrates the continued efforts of the IRA to attribute value to activities that result in development or enhancement of marketing intangibles. However, the challenge for taxpayers and tax authorities alike is to grapple with how it is to be applied and implemented.

To conclude, it can be inferred that the principles laid down by the Delhi High Court will help in restoring the confidence of MNEs and thereby increasing their footprints in India. ■