Transfer Pricing Alert

May 2015

Transfer Pricing of Advertisement, Marketing and Brand Promotion expenses -

An analysis of Delhi High Court ruling in the case of *Sony Ericsson Mobile Communications India Pvt. Ltd.**

Transfer Pricing dispute on account of benchmarking of the marketing intangible resulting from Advertising, Marketing and [brand] Promotion expenses (AMP expenses) incurred by the Multi-National Enterprises (MNEs) operating as licensed manufacturers or distributors in India, has been the bone of contention and has been engaging attention of the courts for some time. Countries such as Australia and New Zealand have adopted OECD guidelines as part of their Transfer Pricing legislation, empowered the tax authorities to examine the AMP expenses incurred by the taxpayers and make adjustments if adequate compensation is not received by taxpayers for performing the marketing function. US Transfer Pricing regulations authorize the tax administration to make allocations among the members of the controlled group if the income of the controlled taxpayer do not confirm to the arm's length standard. Tax administration in China, too, makes similar adjustments with respect to selling and marketing functions performed by the distribution entities.

The tax administration in India applied a 'Bright Line Test' ("BLT") of comparing AMP expenses incurred by the taxpayer with that of the comparable companies for ascertaining excessive expenses on AMP, which was regarded as constituting an 'international transaction' of rendering of service of creating marketing intangible which belonged to the overseas associated enterprise ("AE").

It has been the contention of the taxpayers that the Indian transfer pricing regulations as such do not provide for benchmarking of AMP expenses incurred unilaterally, at its own discretion, through unrelated Indian parties, for purpose of business, in order to cater to local market needs. There was a decision rendered by the Special Bench in the case of *LG Electronics India Pvt. Ltd. (ITA 5140/Del/2011)* taking a view against the taxpayers and affirming the BLT applied by the Revenue for undertaking the benchmarking of AMP expenses. The majority of the Special Bench concluded that incurring of proportionately higher AMP expenses by the taxpayer for promotion of a

foreign brand belonging to the AE lead to an inference of existence of an 'international transaction' of rendering of service of promoting the foreign brand and creating marketable intangible which belongs to the AE.

The Delhi High Court in the case of *Sony Ericsson Mobile Communications India Pvt Ltd vs CIT (ITA No 16/2014)* and reported as *276 CTR 97 (Del)* considered a batch of 17 connected appeals and cross-appeals, dealing with the Transfer Pricing dispute related to marketing intangible. The Court rejected taxpayer's contention that AMP expenses do not give rise to international transactions since in those cases, the taxpayers admitted that the international transactions between them and the AE included the cost/ value of the AMP expenses, incurred in India.

The Delhi High Court laid down significant transfer pricing principles, viz., (a) BLT applied by the Revenue has no statutory mandate, and the contention of the Revenue that any excess expenditure beyond the bright line should be regarded as separate international transactions is unwarranted; (b) clubbing of closely linked transactions is permissible; (c) benchmarking of a bundle of transactions applying entity wide Transactional Net Margin Method ("TNMM") is permissible; (d) once the Revenue accepts the TNMM as the most appropriate method, then it would be inappropriate for the Revenue to treat a particular expenditure like AMP as a separate international transaction; and (e) compensation for AMP expenses could also be benchmarked under Resale Price Method ("RPM") or cost plus method. The Court emphasized that transfer pricing is an income allocating exercise and should not result in over taxation or double taxation and concluded that when TNMM or RPM adopted and applied show that the net/ gross profit margins are adequate, no further transfer pricing adjustment on account of AMP expenses would be warranted.

The moot question is whether expenditure on advertising and brand promotion, incurred by the taxpayer operating in India as an independent manufacturer or distributor having a license to use the brand name of an overseas entity, would be construed as expenses incurred for rendering service of promoting brand of the overseas AE and creating marketing intangible belonging to the AE. It needs to be considered as to how and in what circumstances functions of the taxpayer, performed by incurring AMP expenses, would be regarded as functions performed for or on behalf of the AE, so as to create an obligation requiring arm's length compensation. Answer, to some extent, could be found in the decision of the Delhi High Court, itself:

(i) The Court recognized that the foreign AE and the Indian AE are two separate tax centers and taxable entities. Refer para 117 of the order.

(ii) The Court disapproved the BLT saying that such broad-brush approach of comparing expenses is not mandated or prescribed under the law (refer para 120 of the order) and noted that mere incurring of excessive AMP expenditure cannot be the basis for construing an 'international transaction'. Refer para 120 of the order.

(iii) The Court while distinguishing the functional profile of the limited risk distributor and full risk distributor, held in paragraph 124 that a true distributor, who is in an independent business, uses his own money for

purchasing at a low price and selling at a high price and accordingly shoulders the burden in case of a bad judgment.

(iv) The Court in para 134 of the order held that para 6.36 to 6.38 of the OECD guidelines are not relevant in cases of entities having economic ownership of the trademark. Further, in paras 151 & 153, recognizing the concept of economic ownership of a trade name or trade mark, the Court held that no transfer pricing adjustment in respect of AMP expense can be made where the taxpayer (Indian entity) has economic ownership of the brand/logo/trademark in question by virtue of long term right to exploit the same.

It is a welcome and significant judgment in the arena of transfer pricing. The ruling lays down the broad parameters to be applied in case of AMP spend adjustments which would serve as a guiding principle. The Courts would, however, still have to be dealing with the question in case of independent licensed manufacturer(s) or distributor(s) incurring AMP expenses on their own behalf as principals. It would have to be seen whether unilateral incurring of AMP expenses is pursuant to unison or influence of the AE to regard the taxpayers as agents for incurring such AMP expenses, to construe an 'international transaction'.

....

The appeal was argued by Mr. Ajay Vohra, Senior Advocate, who was assisted by Mr. Neeraj Jain, (neeraj@vaishlaw.com) Partner heading Transfer Pricing at Vaish Associates, Advocates.

All rights reserved.
© Vaish Associates, Advocates
1st & 11th Floor, Mohan Dev Building,13, Tolstoy Marg, New Delhi-110001, India

Disclaimer:

While every care has been taken in the preparation of this Transfer Pricing Alert to ensure its accuracy at the time of publication, Vaish Associates assumes no responsibility for any errors which despite all precautions, may be found therein. Neither this alert nor the information contained herein constitutes a contract or will form the basis of a contract. The material contained in this document does not constitute/ substitute professional advice that may be required before acting on any matter. All images, pictures, logos and trade marks appearing in the Alert are property of their respective owners.

www.vaishlaw.com

DELHI
1st & 11th Floor
Mohan Dev Building
13, Tolstoy Marg
New Delhi - 110001, India
Phone: +91-11-4249 2525
Fax: +91-11-2332 0484
delhi@vaishlaw.com

MUMBAI
106, Peninsula Centre
Dr. S. S. Rao Road
Parel
Mumbai - 400012, India
Phone: +91-22-4213 4101
Fax: +91-22-4213 4102
mumbai@vaishlaw.com

GURGAON
803, Tower A
Signature Towers
South City-I, NH-8
Gurgaon - 122001, India
Phone: +91-124-454 1000
Fax: +91-124-454 1010
gurgaon@vaishlaw.com

BENGALURU
Unit # 305,
Prestige Meridian-II
Building No. 30, M. G. Road
Bengaluru - 560001, India
Phone: +91-80-40903581/ 88 /89
Fax: +91-80-40903584
bangalore@vaishlaw.com