Issue of Marketing Intangibles in India-Breath of Fresh Air

In India, the issue of marketing intangibles has been the most contentious transfer pricing issue. In the last couple of years, multinational companies across India have confronted significant amount of transfer pricing adjustments by virtue of this issue. The Delhi High Court ('DHC') in a landmark judgment in the case of Sony Ericsson Mobile Communication India Private Limited vs. CIT (ITA No. 16/2014 - taxsutra.com) and various other taxpayers[1] (engaged in distribution business), ruled on the transfer pricing issue of excessive advertisement, marketing and promotional ('AMP') expenses incurred by the Indian affiliate of multinational enterprises. In this ruling, the DHC has laid down many important principles for dealing with the AMP issue. The author in this article examines this judgment from the perspective of various open questions that have emerged after this DHC ruling. Read on...

The Issue

The dispute with regard to marketing intangibles arose at the time of transfer pricing scrutiny, when the transfer pricing officer ('TPO') alleged that the taxpayer had contributed in the development of the brand (legally owned by its parent company outside India) by incurring excessive or non-routine AMP expenses. Further, the TPO had contended that such contribution considered as a service provided by the taxpayer to its Associated Enterprises ('AE'). Accordingly, the excessive AMP (advertisement, marketing and promotional) expenditure was considered as an international transaction under the Indian transfer pricing regulations. Further, the TPO had contended that since the taxpayer did not receive any compensation for such excessive or non-routine AMP expenses, it should be compensated for such expenses on the basis of arm's length results.

In order to benchmark the excessive AMP expenses and to compute the arm's length price, the TPO had applied bright line test (a concept that originated from the international ruling in the case of *DHL Corporation & Subsidiaries vs. Commissioner* in USA). The TPO had compared the AMP expenses incurred by the taxpayer with the AMP expenses incurred by the third party comparable companies.

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[1] There are 17 connected matters related to several taxpayers including appeals and cross appeals filed by the taxpayers and by tax authorities

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Based on the same, the TPO had made adjustments to the income of taxpayer on account of such a difference.

The History

The aforesaid controversy enflamed when the DHC in case of *Maruti Suzuki Limited [TS-212-ITAT-2013(DEL)-TP]* upheld that the excessive AMP incurred by the Indian taxpayers resulted into brand promotion of its AE. However, the said ruling was remanded back to the tax authorities by the Supreme Court.

Since the issue of marketing intangibles had become the key transfer pricing issue for many taxpayers across India, the Income Tax Appellate Tribunal ('ITAT') had constituted a Special Bench ('SB') in the case of *LG Electronics India Private Limited vs. ACIT [2014] 146 ITD 165 Del* ('LG Electronics'). The SB in the case of LG Electronics rejected the contentions of taxpayers and upheld that the AMP expenses incurred by the taxpayer for creating or improving the marketing intangible for and on behalf of AE is permissible.

The Delhi High Court in the case of *Sony Ericsson Mobile Communication India Private Limited vs. CIT (ITA No. 16/2014- taxsutra.com)* and various other similar matters pronounced its ruling on the issue of marketing intangibles. It is a path breaking ruling which gave emphasis on the fundamentals of the transfer pricing while dealing with this issue. Principles laid down in this ruling have various deviations from those upheld by the SB of the Delhi Tribunal. In a nutshell, this ruling is a welcome move towards the resolution of this contentious transfer pricing issue.

The Debate

The whole debate around the issue of marketing intangibles can be summarised in the following key points:

- Whether contribution in brand promotion can be considered as international transactions under Indian transfer pricing regulations
- Aggregation of transaction and use of transactional net margin method ('TNMM')
- Whether the concept of economic ownership exists in real sense
- Whether bright line test is a valid method to compute the arm's length price of AMP transaction
- Treatment of selling and distribution expenditure.

Let us evaluate each of the aforementioned questions in the light of the DHC ruling.

I. Whether AMP expenditure is an international transaction

In the submissions before tax authorities, the taxpayer had made the following contentions:

- No such transaction existed in the absence of any understanding between the AEs and the Indian taxpayer
- The parent company has not availed itself of any benefit by the AMP expenses incurred by taxpayer in India.

In view of the above, the taxpayer had contended that the AMP expenses were out of the purview of the *international transaction* as per the Indian transfer pricing regulations.

The SB in the case of *LG Electronics* has upheld that in view of the provisions of the Section 92B read with the explanation (i)(d) to Section 92B of the Income-tax Act, 1961 ('the Act'), an agreement between AEs can be formal or informal/written or oral, therefore, what is relevant is the conduct of the parties to the transaction. Therefore, it gives rise to an international transaction under the Indian transfer pricing regulations.

The DHC has rejected the contentions of the taxpayer and held that the declared price of *international transactions* included the remuneration for their AMP function; the argument that it is not *international transaction* is incorrect. Further, the DHC has also held that a separate reference to the TPO is not required once the primary international transaction related to distribution activity is referred.

II. Aggregation of transaction and use of TNMM

The DHC has held that in a situation where multiple transactions are so interlinked that they cannot be evaluated on separate basis, aggregation of transaction is both desirable and permissible. The DHC has held that the fundamental part of analysis is to find out the characterisation of entity which has incurred non-routine or excessive AMP expenses.

It has held that the tax authorities should conduct a detailed *functions assets and risk* analysis to examine whether the functions performed by taxpayers are of a pure distributor or performing both distribution and marketing functions. If the distribution and marketing functions are interrelated, the arm's length price can be computed by aggregating both the functions.

The DHC has further analysed whether TNMM method can be applied to benchmark AMP expenses. It has held that once the TPO accepts and adopts the TNMM and then chooses to treat a particular expenditure like an AMP as a separate international transaction without bifurcation/segregation, it would lead to unusual and incongruous results. Furthermore, in the case of the Resale Price Method, the High Court held that if gross profit margins match or are within the specified range, no transfer pricing adjustment is required in the case of AMP. In such cases, gross profit margin would include the margin or compensation for the incurred AMP expenses.

The SB ruling in case of *LG Electronics* has laid down the dictum in case of a licensed manufacturer. The DHC ruling is concerning the distributor. Now the question arises whether the aforesaid principle laid down by the DHC can actually be applied to a *licensed manufacturer*. In most of the cases, a licensed manufacturer operates as entrepreneur and is responsible for the rewards for the functions performed and risk assumed, and it is wholly responsible for the residual profits/losses in its territory after making the payment for *international transaction* with AE at arm's length basis. In this scenario, the licensed manufacturer, incurring non-routine AMP expenses, is not contributing in the promotion of brand of its parent company and the whole issue of marketing intangibles is irrelevant in this case. In other words, if any non-routine expenses incurred by the licensed manufacturer are for its own business and the licensed entrepreneur only reaps benefit from such non-routine marketing efforts, the licensed manufacturer is not entitled to get compensation from its AE for the non-routine or excessive AMP spend.

However, there may be a scenario where a licensee makes substantial investments in promoting the brand of its AE or parent company. In such a scenario, the principle laid down by the DHC ruling can be applied and if the margin of the licensed manufacturer is higher than margin earned by the comparable companies (applying TNMM method), the non-routine AMP expenses can be considered to be at arm's length. Alternatively, the excess AMP costs borne by the licensee can be compensated by relatively lower or a declining royalty rate.

It is important to note that the guidance provided by *Organization of Economic Co-operation and Development* ('OECD') and *Australian Tax Office* ('ATO') are in the context of marketers/distributors and not for license manufacturers. This makes it evident that both these esteemed organisations too do not support the issue of marketing intangibles to arise in the context of license manufacturers. As per the said guidance, a normal distributor undertaking normal risks, if it performs extra functions on account of marketing and advertisement front as compared to independent distributors in market, the distributor should be remunerated for the cost incurred on such extra functions. Further, such remuneration can come either in the form of reduction in purchase price of products or through a reimbursement for excess or non-routine AMP expenses.

III. Whether the concept of economic ownership exists in real sense

There are two elements of returns related to a brand, namely one for legal ownership, and the other for economic ownership. The economic owner of an intangible asset enjoys the benefit from the income generated by the

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intangible it creates and owns. For example, where any manufacturer or a distributor performs significant marketing functions, undertakes risks and takes decision for framing the marketing strategies as a licensee of brand, the distributor becomes economic owner of such marketing intangible developed by it its jurisdictions.

The taxpayers alleged that even in a scenario, where the AMP expenditure led to the creation of marketing intangibles for the AE, the economic ownership of such intangibles rests with the Indian entity and hence, the Indian entity need not be remunerated for its marketing efforts.

As per the SB ruling in case of *LG Electronics*, economic ownership of a brand exists only in a commercial sense, and in the context of the Indian Income-tax Act, 1961, it is only legal ownership which is recognised. The DHC decision has given importance to the concept of economic ownership in case of distributors. Such importance cannot be understated due to the fact that economic ownership is the key fact to find out while performing functional analysis for transfer pricing purposes.

The DHC has upheld that the economic owner must be adequately compensated for its economic ownership in event of alienation of intangibles. Further, the court held that economic ownership of a trade name or trade mark is accepted in international taxation as one

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of the components or aspects for determining transfer pricing. Economic ownership when pleaded can be accepted if it is proved by the taxpayer.

The revised OECD discussion draft on the transfer pricing aspect of intangibles also provides guidance in relation to the arm's length value of intangibles based on the economic activities performed by the entity. Economic ownership is a reality and one cannot get appropriate arm's length results without considering the economic owner and its return attributable in development of intangible.

IV. Whether bright line test is a valid method to compute arm's length price

As per the SB in the case of *LG Electronics*, Bright Line is a 'way of finding out the cost/value of international transaction. The Special Bench in effect concurred with the Revenue who referred to Bright Line as a 'tool' to ascertain the cost of the international transaction.

The DHC held that there was nothing in the Act or Rules to hold that it was obligatory for the AMP expenses to be subject to 'Bright Line Test' and the non-routine AMP expenses as separate as a separate international transaction. The Court has granted relief to the taxpayers by holding that if aggregated transaction is concluded to be at ALP by applying TNMM or RPM, there is no need to bifurcate and treat AMP expense as separate international transaction.

This was a crucial relief for the taxpayers who have suffered significant transfer pricing adjustment with the application of bright line test since bright line methodology does not match or inconsistent with the arm's length principle. Although the High Court has not specifically mentioned the methodology for computing the AMP adjustment, it has provided detailed guidance on fundamentals of transfer pricing while dealing with this issue.

V. Treatment of selling and distribution expenses

The Special Bench ruling had upheld that selling and distribution expenses (discounts, commission, sample expenses, trade incentives, *etc.*) do not form a part of the AMP expenses and hence, these expenses cannot be considered while computing the bright line test. The DHC has agreed with the SB and held that direct marketing and sales related expenses are not directly linked to brand building but have a direct and immediate connect with increased sales.

Conclusion and the Way Forward

The DHC ruling is quite welcoming, since it has provided a roadmap to deal with this contentious issue. The DHC has held that transfer pricing regulations are anti-avoidance provisions and it should be invoked selectively and must not result in double taxation.

The DHC has given emphasis to the fundamentals of the transfer pricing principles while computing the arm's length price of the AMP transaction. The DHC judgement broadly rejects the application of bright line methodology since it has no statutory mandate. The DHC has granted relief to the taxpayers while holding that if bundled transactions are concluded to be at arm's length by applying TNMM or RPM, then there is no need to bifurcate and treat AMP as a separate transaction.

While this ruling has given much clarity on this issue, there are some open question on which debate could arise such as how the arm's length price of the AMP transaction is to be computed where it is not possible to aggregate the transactions, say for example, where the taxpayer applied *Comparable Uncontrolled Method* for benchmarking its routine transaction (other than AMP expenses). Further, where the taxpayer believes that its whole AMP expenditure is routine and it has not incurred any non-routine expenses towards promotion of brand, in this scenario, the key question is whether the taxpayer is required to report its AMP expenses as international transaction.

The issue of marketing intangibles is factual in nature. The DHC has pronounced its ruling in case of distributor considering the facts of the case. It is very important to apply the key transfer pricing principles for computing the arm's length price of the AMP transaction. For dealing with this issue, a detailed *functions, assets and risk analysis* plays a vital role to get a detailed understanding of the taxpayer's functions and it's characterisation for transfer pricing purposes. In view of the same, it is very important for the taxpayer to analyse the following in detail and maintain robust documentation in order to justify the arm's length nature of its AMP expenses:

- Characterisation of each entity involved in transaction;
- Level of marketing efforts performed by the Indian entity; and
- Licensing arrangement. ■