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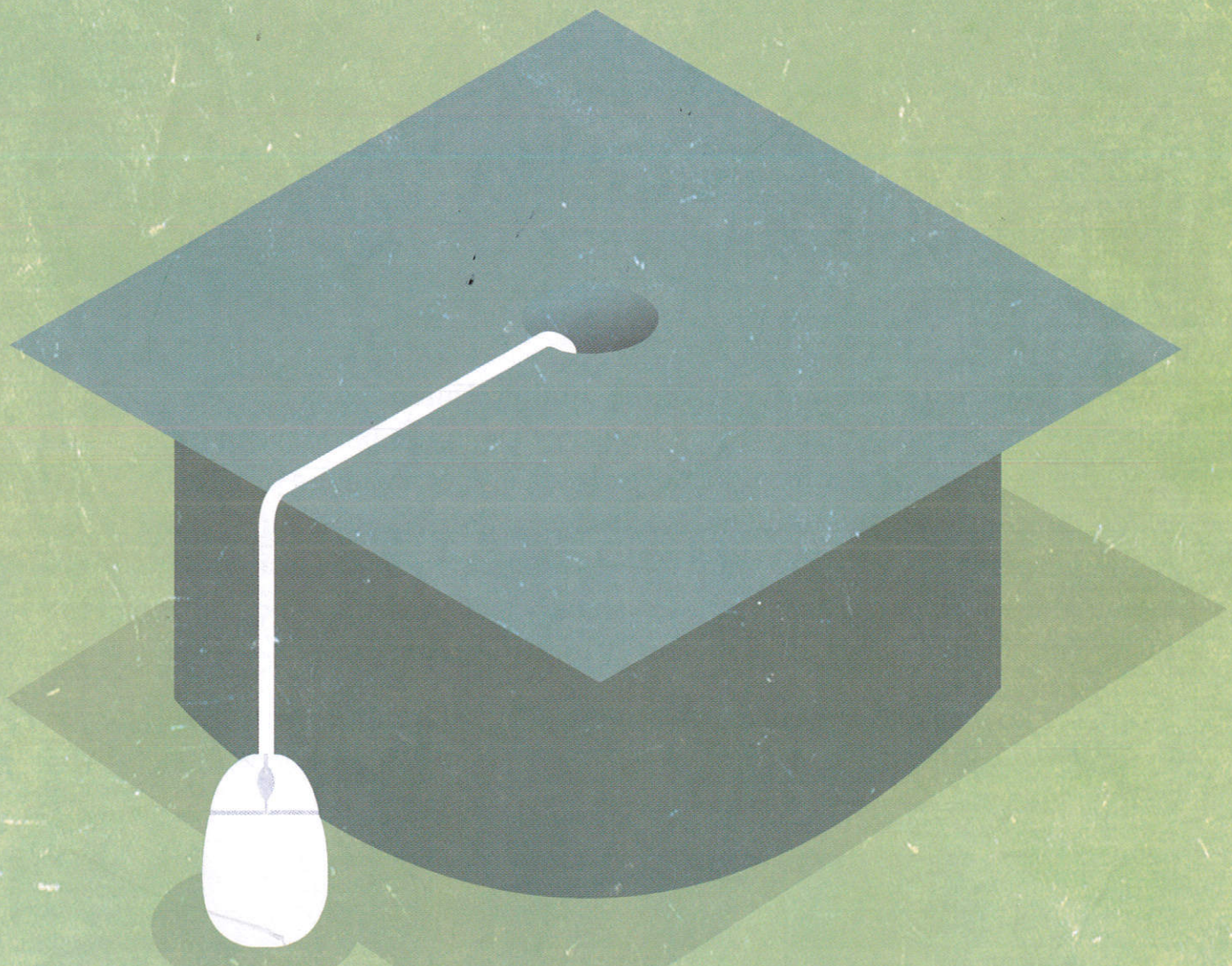

DIGITAL TRENDS IN HIGHER EDUCATION

AMP: A CONTROVERSY FAR FROM OVER

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BACKGROUND

Over the past decade, Indian Revenue has been the centre of global attention for its positions on controversies surrounding tax and transfer pricing. In the last few rounds of Transfer Pricing assessments, taxpayers promoting international brands in India have been scrutinised for the level of Advertising, Marketing and Promotion ('AMP') expenses incurred by them. These issues largely affected multinational enterprises ('MNEs') in consumer durables, electronics, automotive and media sectors. The controversy snowballed, leading to constitution of a three-member Special Bench of the Income-tax Appellate Tribunal ('Appellate Tribunal'), for expert examination of the issues involved. Dissatisfied taxpayers later escalated the issue to the High Court and the same is now pending with the Indian Supreme Court. The most interesting aspect of the AMP controversy is the manner in which this issue has evolved in the judicial hierarchy. While some contentious issues are gradually dwindling as they move up the appellate forums, some issues remain unresolved and with each resolution come new challenges in practical implementation. In the next few paragraphs, we have attempted to summarise the controversy, the evolving judicial elucidation and some unresolved issues.

AMP IN THE INDIAN LANDSCAPE

Under a typical license/distributor arrangement, the Indian entity of a MNE group uses the international brand/ trademark to sell its products in India. For doing so, the Indian entity would pay royalty for using such brand/ trademark. In order to spread awareness of the products and increase/maintain the market share of the products manufactured or distributed by them in India, the Indian entity would incur expenses on advertising, marketing and promotion of such brand/trademark.

During the course of Transfer Pricing assessments, the Indian Revenue has consistently been taking a position that the Indian entity of the MNE group provides assistance to the overseas affiliate, legal owner of the brand/trademark, by enhancing or building the international brand/trademark in India. According to the Revenue, AMP expense beyond the level of expense incurred by comparable businesses (termed as 'Bright Line Test' or 'BLT') is non-routine and the same results in creation of marketing intangibles for the legal owner of the brand. Transfer Pricing adjustments have been made on the premise that the Indian entity ought to recover the excess costs along with an appropriate mark-up for such assistance.

ADVENT OF THE AMP CONTROVERSY

The issue of AMP came to limelight in 2010, when the Delhi High Court pronounced a ruling in response to a writ petition filed by Maruti Suzuki[1] challenging the show cause notice issued by the Transfer Pricing Officer. The High Court remarked that if the intensity of AMP expenses (defined by a ratio of AMP expense to sales) by the Indian taxpayer is more than what a comparable company would incur, the Indian taxpayer should be compensated at arm's length, particularly when the use of trademark or logo of the foreign affiliate is obligatory on the part of the Indian taxpayer. With a shot in the arm, the Revenue Authorities made several transfer pricing adjustments in cases of distributors, licensed manufacturers, service providers, *etc.* using international brands. Without appreciating the difference in functional characterisation, business model and industry life-cycle of the Indian taxpayers, the Indian Revenue painted everyone with the same broad brush and made transfer pricing adjustments for excess AMP expenses.

The Indian Revenue seems to have taken inspiration from the US Tax Court ruling in the year 1998 in the case of DHL[2], which was subsequently reversed by Ninth Circuit US Court of Appeal[3]. In the case of DHL, the Tax Court asked the taxpayer to prove that it incurred more than routine AMP expenses outside US, in order to substantiate that it was the developer of the non-US rights

1 *Maruti Suzuki India Limited vs. Addl. CIT TPO [W.P.(C) 6876/2008] [2010] 328 ITR 210 (Del)*
2 *DHL Corporation & Subsidiaries vs. Commissioner of Internal Revenue (T.C. Memo.1998-461, December 30, 1998)*
3 *DHL Corporation & Subsidiaries vs. Commissioner of Internal Revenue (Ninth Circuit Court ruling, April 11*

of trademark/brand. However, the Ninth Circuit Court of Appeal rejected the approach of the Tax Court holding that there was no such requirement of comparing the AMP expenses incurred by the taxpayer with comparable companies under 1968 Regulations.

EVOLUTION OF TRANSFER PRICING JURISPRUDENCE ON AMP IN INDIA:

As the Delhi High Court ruling on Maruti Suzuki's writ petition led to a plethora of transfer pricing adjustments for AMP spends, affected taxpayers filed appeals to challenge their legality. The Appellate Tribunal, in one such case, deleted the transfer pricing adjustment on the technical ground that the Transfer Pricing Officer had no jurisdiction to assess any transaction which was not specifically referred by the tax officer assessing the case. The Revenue challenged this technical ground before the High Court but failed, with no discussion being recorded on merits of the transfer pricing adjustment. To overturn this defeat in 2012, the Indian Government amended the transfer pricing provisions through Finance Act, 2012. In the amended provisions, the term 'intangible property' was defined to include, *inter alia*, 'marketing related intangible assets', such as trademarks, trade names, brand names, logos, *etc.* Further, Transfer Pricing Officers were bestowed with the right to test transactions even if not specifically referred by the tax officer. After these amendments, the Appellate Tribunals started adjudicating the AMP issue on merit. However, a disparity in the decisions in different cases created uncertainty around the transfer pricing implication of AMP expenses. Considering the conflicting decisions, the importance and the complexity of the issue, a three-member special bench was constituted by the Appellate Tribunal to adjudicate on the transfer pricing aspects of AMP expenses.

SPECIAL BENCH RULING IN THE CASE OF LG ELECTRONICS INDIA PRIVATE LIMITED[4] (LG INDIA):

The appeal before the Special Bench of the Appellate Tribunal was led by LG India, while other Indian taxpayers[5] also affected by the issue joined as interveners to the case. The key findings of the Special Bench were as under:

- AMP expenses incurred by an Indian taxpayer result in creating and improving marketing intangibles for the overseas affiliates
- Expenses for the promotion of sales directly lead to brand building, the expenses incurred directly in connection with sales are only sales specific
- In addition to promoting its products through advertisements, LG India simultaneously promoted the foreign brand
- The concept of economic ownership does not find place under the Indian tax law. It is the legal owner of the brand who is benefitted
- If the level of AMP expenses incurred by the Indian taxpayer is in excess of that of comparables, the excess AMP ought to be recovered by the Indian taxpayer from the overseas affiliate along with appropriate mark up
- Selling expenses which do not lead to brand promotion do not form part of AMP expenses and hence to be excluded for the purpose of benchmarking.

Subsequent to the decision of the Special Bench, most cases pending before the Appellate Tribunal were sent back to the Transfer Pricing Officers with specific direction to follow the principles laid down by the Special Bench in the LG India case. This resulted in transfer pricing adjustments in many cases, barring some relief on account of exclusion of routine sales expenses from the ambit of AMP spends.

DELHI HIGH COURT RULINGS

In the case of Sony Ericsson[6] :

Aggrieved by the order of the Appellate Tribunals following the decision in LG India, taxpayers (including consumer electronics and consumer durables giants like Daikin, Haier, Reebok, Canon and Sony) appealed before the High Court. While adjudicating the case of Sony Ericsson, the High Court laid out the following broad principles:

- Upholding the decision in LG India, AMP expenses were treated as an international transaction with associated enterprise ('AE') and thus subject to Transfer Pricing Regulations in India

4 *L.G. Electronics India Private Limited vs. Asstt. Commissioner of Income Tax (ITA No. 5140/Del/2011)*

5 *Haier Telecom Pvt. Ltd; Goodyear India; Glaxo Smithkline Consumer India; Maruti Suzuki India; Sony India; Bausch & Lomb; Fujifilm Corporation; Canon India; Diakin India; Amadeus India; Star India; Pepsi Foods India*

6 *Sony Ericsson Mobile Communication India Pvt. Ltd vs. Commissioner of Income-tax (ITA No. 16/2014) (Del)*

- Excess AMP expenses incurred by Indian taxpayers warrant a compensation, but BLT is not well suited for computing the same

- Distribution and marketing are intertwined functions and should be analysed in a bundled manner for determining arm's length remuneration, unless need for de-bundling is adequately demonstrated

- If under bundled approach, the gross margins or net margins of the Indian taxpayers are sufficient to cover the excess AMP expenses, then a separate remuneration for such excess from the foreign affiliate is not required

- If the distribution and marketing functions are to be de-bundled then the taxpayer should be allowed a set-off for additional remuneration in one function against a shortfall in the other function

- In order to apply bundled approach using an overall Transactional Net Margin Method ('TNMM') / Resale Price Method ('RPM'), it must be ensured that the level of AMP functions in comparables should be similar to that of the Indian taxpayer or the tested entity

- An attempt be made to find comparables with similar level of AMP functions and if such comparables cannot be found then proper adjustment be made to even out the differences

- All the AMP may not necessarily result in brand building

- The concept of economic ownership of intangibles was recognised.

The High Court also suggested that the Appellate Tribunals try to adjudicate the pending cases (rather than remitting the same to the Transfer Pricing Officer) following the broad principles laid down in the case above. However, the Appellate Tribunals have been remitting the issue back to the Transfer Pricing Officer on the ground that no analysis has been carried out in respect of comparability in the level of AMP functions.

IN THE CASE OF MARUTI SUZUKI[7]

The case of Maruti Suzuki was also made a part of the appeals heard by the Delhi High Court along with that of Sony Ericsson (*supra*). However, as against the other appellants alongside Sony Ericsson, who were primarily distributors of their AEs' products, Maruti Suzuki was a manufacturer. The appeal of Maruti Suzuki was thus de-linked and heard separately by the High Court. In its ruling, the High Court clearly distinguished the facts of the case from its earlier decision in Sony Ericsson. The High Court's observations were made taking into consideration the specific profile of a manufacturer in the AMP scenario. Further, the High Court re-examined the applicability of Chapter X of the Income-tax Act, 1961 ('Act') to the AMP issue, since the existence of an international transaction was specifically questioned by the taxpayer. The observations of the High Court were as under:

- The Court noted that Chapter X of the Act makes no specific mention of AMP expenses as one of the items of expenditure which can be deemed to be an international transaction.

- Even if the same is considered to be covered under "any other transaction having a bearing on its profits, incomes or losses", for a transaction to exist there has to be two parties. Therefore, the onus is on the Revenue authorities to show that there exists an 'agreement' or 'arrangement' or 'understanding' between Maruti Suzuki and its AE, whereby Maruti Suzuki is obliged to spend excessively on AMP in order to promote its AE's brand[8].

- A transfer pricing adjustment envisages substitution of price of an international transaction with ALP. An adjustment is not expected to be made by deducing that an international transaction exists based on difference between AMP expenses of the taxpayer and comparable entities.

- By applying BLT, the Revenue Authorities had deduced the existence of an international transaction on excessive AMP spend of Maruti Suzuki, and then added back the excess expenditure as transfer pricing adjustment. This was contrary to the High Court's approach, which required the Revenue Authority to examine an international transaction. The High Court observed that the very existence of an international transaction cannot be matter for inference or surmise.

7 *Maruti Suzuki India Limited vs. Commissioner of Income-tax (ITA 110/2014; ITA 710/2014) (Del)*

8 With reference to meaning of 'international transaction' u/s. 92B(1) if the Act and meaning of 'transaction' u/s. 92F(v) of the Act

- In the absence of international transaction involving AMP spend with an ascertainable price, neither the substantive nor machinery provisions of Chapter X of the Act are applicable to the transfer pricing adjustment exercise.

IN THE CASES OF HONDA SIEL[9] AND WHIRLPOOL[10]

The Maruti Suzuki ruling has apparently set the precedence for the interpretation of AMP spend in the case of manufacturers. Subsequent rulings have followed the distinct perspective of the High Court and questioned the existence of an international transaction merely on account of excessive AMP expenditure:

In the case of Honda Siel:

- The High Court observed that the Revenue Authorities ascertained existence of an International transaction only by applying the BLT. Accordingly, the High Court distinguished the case from its earlier Sony Ericsson ruling.

- The High Court also observed that mere existence of a license for use of the AE's brand name would not ipso facto imply any further understanding or arrangement between the taxpayer and its AE regarding the AMP expense for promoting the brand of the foreign AE.

- Further, the High Court also noted that since the taxpayer was an independent manufacturer, it was incurring AMP expenses for its own benefit and not at the behest of the AE.

- In the absence of any categorical evidence provided by the Revenue Authorities, the High Court followed the Maruti Suzuki decision and ruled out the existence of an International transaction.

IN THE CASE OF WHIRLPOOL:

- The High Court observed that the provisions under Chapter X of the Act do envisage a 'separate entity concept'. Therefore, there cannot be a presumption that since the taxpayer is a subsidiary of the foreign AE, its activities are dictated by the AE.

- Once again, the High Court put the onus on the Revenue Authorities to factually demonstrate through some tangible material that the two parties acted in concert, and further, that there was an agreement to enter into an International transaction concerning AMP expenses.

- Regarding the deductibility of AMP expenses u/s. 37 of the Act, the High Court ruled in favour of the taxpayer and held that merely because the AE is also benefitted by the AMP expenses, their allowability is not precluded.

SUBSEQUENT CASES

The Delhi High Court as well as the Appellate Tribunal have been speedily disposing cases covering AMP issues by following the ratio laid down in the Sony Ericsson and Maruti Suzuki rulings. An unspoken trend seems to have been set in the pattern of disposal – while the Sony Ericsson ruling is being followed in the case of appellant who are distributors, the Maruti Suzuki ruling is being followed in the case of manufacturers.

- In the case of Haier Appliances[11], the Appellate Tribunal observed that for application of RPM, it is necessary to examine the comparability of the AMP functions performed by the Appellant with those of the comparables. In the absence of adequate information to this effect, the case was remanded back to the Revenue Authorities for fresh consideration. However, the Appellant being a distributor, the presence of an international transaction was not negated (following the ruling in Sony Ericsson case).

- Similarly, in the case of Johnson & Johnson[12], the Appellate Tribunal held that the Revenue Authorities are duty bound to apply the existing methods under the Act (as against BLT, which has been rejected in the Sony Ericsson ruling).

- The case of Yum Restaurants[13], was remitted back by the High Court for further examination of the franchise marketing model in question. The Sony Ericsson ruling was followed in this case as well. However, here the High Court held that once a transfer pricing adjustment has been made for AMP expenses, the said expenses cannot be disallowed again u/s.40A(2)(b) of the Act.

9 *Honda Siel Power Products Limited vs. Deputy Commissioner of Income-tax [2015] 64 taxmann.com 328 (Delhi)*

10 *Commissioner of Income-tax – LTU vs. Whirlpool of India Limited [2015] 64 taxmann.com 324 (Delhi)*

11 *Haier Appliances India Limited vs. DCIT, OSD, CIT-IV [2016] 65 taxmann.com 74 (Delhi – Trib.)*

12 *Johnson & Johnson Limited vs. Addl. CIT - LTU (ITA No. 829/M/2014)*

13 *Yum Restaurants (India) (P.) Ltd. vs. Income-tax Officer [2016] 66 taxmann.com 47 (Delhi)*

- The case of Bausch & Lomb[14] involved manufacturing as well as trading activities. Here, the High Court ruled out the existence of an international transaction, following the Maruti Suzuki ruling. Further, the High Court also observed that 'function' needs to be distinguished from 'transaction' and that every expenditure forming part of a function cannot be construed as a 'transaction'.

IS IT THE END OF THE AMP CONTROVERSY?

The year 2015 witnessed disposal of several cases by the Delhi High Court and various benches of the Appellate Tribunal. While moving steadily ahead in its appellate journey, the AMP controversy still seems to be far from over.

A special leave petition ('SLP') has been filed before the Indian Supreme Court by affected taxpayers challenging the ruling of the Delhi High Court in the case of Sony Ericsson. The coming months are likely to reveal the taxpayers' and Revenue's responses to the other rulings of the High Court.

The High Court has not negated the existence of an international transaction where there is excessive AMP spend by Indian distributors. In such cases, the High Court has emphasised the need for comparability of the level of AMP function between the taxpayer and the independent comparable companies. If companies with comparable AMP functions cannot be found, the High Court directed necessary adjustment to even out the difference in the AMP functions. However, neither the High Court nor the Appellate Tribunals have provided any guidance on determining the level of AMP function or computing adjustment for difference in AMP functions. In absence of clear guidance, another round of litigation seems inevitable.

In the case of manufacturers, the existence of an International transaction has been ruled out in absence of specific provisions under Chapter X of the Act. The High Court has also explicitly expressed the need for a clear statutory scheme to check arbitrariness and address existing loopholes. In view of the same, one could expect some legislative amendments in the transfer pricing provisions in the upcoming budget.

The key issue that needs consideration and deliberation is whether the Indian taxpayers have incurred the AMP expenses in their capacity as service providers or as entrepreneurs on their own account. The issue of compensating for AMP function at arm's length would arise only in case where the Indian taxpayer is incurring AMP expenses in the capacity of a service provider. The answer to this may lie in the functional analysis and conduct of the Indian tax payer and the overseas affiliate. Further, indicative facts like exclusivity, longevity of contract, premium pricing and increase in the market share, *etc.* could be used to demonstrate the economic ownership of the brand. Documentation by the MNE group would play the key role in helping the MNE find answers, determine the course of action and/or build appropriate defense.

Consideration also needs to be given to the mode of remunerating such service. In place of recovering the AMP expenses from the overseas affiliates, MNEs could consider remunerating the Indian taxpayers by way of higher gross margin to cover the AMP expenses. Lastly, while the MNE groups evaluate their value chains in the wake of BEPS, it may be worthwhile to consider the above implications while aligning ownership of intangible property, compensation and related structures. ■

14 *Bausch & Lomb Eyecare (India) (p.) Ltd. vs. Addl. CIT [2016] 65 taxmann.com 141 (Delhi)*