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BRAND PROMOTION EXPENDITURE

A CRITICAL ANAYSIS FROM THE PERSPECTIVE OF INDIAN TRANSFER PRICING

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Abstract

Brand promotional expenditure has become a subject of great interest in the Indian Transfer Pricing circle after the decision of Delhi High Court in the case of *Maruti Suzuki Vs ACIT, TPO*. This expenditure is spent to create an intangible asset even though they may have no book value in the company's Balance Sheet. The decision of the Delhi High Court has triggered a lot of debates as it has proposed an altogether new methodology to determine whether the brand promotional expenditure incurred by the Indian entity benefitted the foreign holding company.

This paper seeks to analyse the brand promotional expenditure from the bird's eye point of view by tracing to its origin (i.e.,*Glaxosmithkline- US Case*) and the methods used by different countries to determine whether brand promotional expenditure is at arm's length. This paper also analyses various decisions of the High Courts (HC) and Income Tax Appellate Tribunals (ITATs) of India.

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1. Introduction

The term 'brand promotional expenditure' itself denotes that it is an expenditure incurred to increase the goodwill of the entity. Although it helps to increase the business of the entity and is incurred during the course of the business it is not associated with direct selling expenditure but considered as an indirect selling expenditure. Goodwill is an intangible and is treated as an asset because of its ability to generate future income. In this era of ruthless competitiveness, it has become imperative for every company to build its good will and to acquire rights over other intangibles than to increase the net worth of their tangible assets since these intangibles, especially goodwill, is capable of creating favorable impression in the minds of the public/distributors about the entity which would benefit the entity in the long run. The economy is no more equating growth with capital and human resource alone but also with intangibles such as new technology, research and development, and advertisement. Pharmaceuticals and other technologically driven companies (such as Automobile, Home appliances, etc) are the leaders in investing in this innovation; 3/4th of their expenditure are towards Research and Development, Patents and advertising. The U.S. IRS even quoted the words of Glaxo's Chairman *Sir Paul Girolami* in support of its argument in the much hyped Glaxo's Transfer Pricing Case:

"any product which makes money doesn't sell itself… you've got to sell it and sell it hard, because if you don't it won't be sold, however good it is"

It is also often quoted in the marketing world that the good will of the Coca-Cola Inc. goes beyond the value of its entire tangible assets.[1] The above examples gives us a clear picture as to how these MNEs are ready to go to any extent and to pay any amount of price for marketing their product. The money spent by the entity towards marketing in turn helps the entity in creating an intangible asset. Marketing is one of the sure shot ways to increase the goodwill of an entity in this highly

[1] *The practical guide to Indian Transfer Pricing by Chamber of Tax Consultants*

competitive economy. Corporates go berserk in promoting their brands by exploiting all the possible ways from media to digital boards to hoardings, et al. These intangible assets can be broadly classified into two types: Goodwill and other identifiable intangibles.[2]

Goodwill can be referred as the premium amount in addition to the fair market value of the entity[3], whereas other identifiable intangibles can be referred to as trade intangibles which can sold/ licenced separately such as Patent, Trademark, Copyright, etc. These identifiable intangibles are protected by Intellectual Property laws and have fixed time of ownership whereas goodwill is conceptualized in the minds of people and can be transferred or licensed along with the business. However, the difficulty lies in determining the value of intangibles as there are no specific scientific methods to determine its value but only on the basis of assumptions. Also, the traditional five methods are found insufficient to determine the arm's length value of the intangibles when there is transfer/license of such intangibles between associated enterprises.

2. Marketing Expenditure in Transfer Pricing

The advertising, marketing and promotional (AMP) expenditure is brought under the ambit of transfer pricing when it is incurred by the distributor of the product. There is no requirement to determine the arm's length range of AMP expenditure when the distributor is of an independent character and there is an arrangement between that distributor and the owner of the product to reimburse all AMP expenditure incurred by the distributor to promote the brand of the owner but the difficulty arises when the distributor is a related party/subsidiary to the owner of the product and there is no arrangement between them regarding the AMP expenditure. In such a situation, it is important to find out whether the distributor is

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[2] *The value relevance and managerial Implications of intangibles: A literature review by Leandro Cañibano of University of Madrid, Manuel García-Ayuso Covarsí of University of Seville, M. Paloma Sánchez of University of Madrid. - One of the project papers of the MERITUM project.*

[3] *http://beginnersinvest.about.com/od/analyzingabalancesheet/a/goodwill-on-the-balance-sheet.htm*

being adequately compensated for the AMP expenditure it has incurred to promote the brand of the owner of the product?

Worldwide, the opinion of authorities are in unison to the above preposition that a distributor should be compensated for the excess AMP expenditure it has incurred over and above what is necessary or common practice (i.e., arm's length). However, there are several different methods propounded by different courts and organizations to decide the arm's length level of AMP expenditure. Let us discuss in detail all the methodologies propounded by different courts and organization.

2.1 DHL Corp. Et al v. Comm'r, T.C. Memo. 1998-461

This decision was the pioneer of Transfer pricing decisions relating to 'marketing intangibles'. DHL is an US incorporated company and in the year 1972 it formed a subsidiary called 'DHLI, Hong Kong' to handle all its international operations. DHL, USA owned the trademark and licensed it to DHLI, Hong Kong royalty-free, since DHLI registered the world-wide trademark and carried on other marketing activities. During the year under consideration, a Japanese company agreed to purchase the DHLI, Hong Kong stock for US$ 450 million and DHL trademark at US$20million in exchange for DHL receiving the right to use the trademark for 15 years royalty-free and at a low royalty for ten years thereafter.

The tax court found the compensation was not adequate, especially with respect to the transfer of trademarks, and held it should be enhanced for taxation purposes. DHL on the other hand argued that DHLI, Hong Kong was the developer (as per the Developer-Assister Rule) of non-US trademark rights and that its value, therefore, should not be allocated to DHL. Alternatively, DHL argued that if DHLI, Hong Kong is to be considered as an assister (as per the Developer-Assister Rule) then DHLI, Hong Kong should be allowed to set-off the amount of assistance it provided for developing the DHL trademark outside USA.

2.1.1 Bright-Line Test:

The US Tax court expressly rejected the argument of DHL and held that DHLI, Hong Kong has not expended more than the arm's length range as per the developer-assister rule itself and hence, DHLI cannot be considered as an owner of the trade mark and determined the value of trade mark as $150 million. The Tax Court's decision was reversed in part by the appellate court; however, the concept of 'marketing intangibles' was upheld.

The Tax court coined 'Bright-Line' test in determining the presence and value of any marketing intangibles. It was propounded to find out whether or not the subsidiary has incurred more marketing expenditure than what is necessary to promote the brand of the holding company. If the test proves positive, then the subsidiary needs to be compensated by way of reimbursement by the holding company and if the test proves negative, then no reimbursement is necessary. The test identifies expenditures as routine and non-routine and determines that the non-routine expenditure ought to be compensated by the holding company and the subsidiary company has to bear the routine expenditure. The Tax Court also propounded that segregation of routine and non-routine expenditure can be done with the help of independent comparables. The amount equivalent to the amount spent (or would have been spent in the similar circumstances) by the independent comparable entity will be considered as the 'Bright-Line limit' i.e., the maximum limit up to which the assister will not be taxed.

2.1.2 Routine and Non-routine Expenditure:

The US transfer pricing regulations differentiates between routine and non-routine expenditure with the 'cheese' examples to clearly explain what should be reimbursed and what should not be.

Ex-1: US subsidiary uses the logo of parent entity for selling its product i.e., cheese. It incurs AMP expenditure which is equivalent to that of the expenditure incurred by an independent cheese distributor to sell his cheese. Parent entity need not reimburse the US subsidiary.

Ex-2: US subsidiary entity uses the logo of parent entity selling its product i.e., cheese, but the expenses incurred are 'Extra-ordinary' when compared to the expenditure incurred by an independent cheese entity. In this case, the parent entity needs to compensate the 'Extra-ordinary' expenses incurred US subsidiary.

Ex-3: US subsidiary is the sole distributor of its parent entity's cheese. It acquired the right by way of a license agreement and incurs significantly larger AMP expenditure when compared to the AMP expenditure of independent distributors. The parent entity need not compensate the US subsidiary since the subsidiary is the 'legal owner' of the marketing intangibles in US.

2.2 Glaxo VS IRS, USA

The year 2006 was marked with a landmark case in the modern transfer pricing history. The IRS, USA and Glaxosmithkline Group ended a 14 year old transfer pricing dispute through a settlement of U.S.$ 3.1 billion over the marketing intangible created by Glaxo, USA for Glaxo, UK by vigorously promoting 10 drugs (including *Zantac*, which contributed 77% of the adjustment made by the IRS)whose patent belonged to Glaxo, UK. The facts apropos to this case are that *Zantac* was researched and developed by Glaxo, UK and was introduced in to the US market much later to the similar kind of drug, *Tagamet*, was introduced by its competitor. However, due to its aggressive marketing promotions Glaxo, USA made *Zantac* as the market leader beating *Tagamet.*

2.2.1 US Law- marketing intangibles:

US transfer pricing regulations works on the principle of legal ownership of the intangibles. If there is no legal owner to the intangibles, the developer-assister rule could be applied to decide the owner.

The right to exploit an intangible can be subdivided in various ways, a single intangible may have multiple owners for purpose of AMP expenditure. Thus, for example, the owner of a trademark may license to another person the exclusive right to use that trademark in a specified geographic area for a specified period of time (while otherwise retaining the right to use the intangible). In such a case, both the licensee and the licensor will be considered owners of that particular brand.

2.2.2 Developer-Assister Rule:

The US IRS made a transfer pricing adjustment and raised a tax deficiency notice on the ground that Glaxo, USA became the legal owner of the marketing intangibles of the drugs as per the Developer-Assister Rule and it need not have paid royalty to Glaxo, UK.

The Developer-Assister rule determines the owner of the intangible in case there is a joint development of an intangible. Developer is a party who bears most of the cost in developing an intangible and assister is the other party. Developer will be considered as the owner and the other joint owner will be considered as an assister. Allocations may be made to the assister by the developer for its role in assisting the brand building. Such assistance may include loans, services, or the use of tangible or intangible property but not the routine-non routine expenditure.

By applying the above principle, the U.S. IRS alleged that Glaxo, USA should not have paid royalties for the usage of trademarks and other marketing intangibles because Glaxo, USA became the owner of the trademarks and other intangibles of Glaxo, UK. The revenue supported its argument by stating that *Zantac* is not a pilot drug as it was introduced much later than *Tagamet* and did not offer a marked enhancement of pre-existing treatments and hence, *Zantac* became the leader of the market in the USA by implementing a redeveloped sales strategy.

Though the case was amicably settled between the parties and does not provide us with any scientific methods to measure the return attributable to the marketing activities, it did ring an alarm bell to transfer pricing circles all over the world.

2.3 OECD's approach:

The OECD guidelines initially provided little guidance as to what constitutes 'marketing intangibles' but addressed the issue as very complicated in terms of determining the value arising out of marketing intangibles. The OECD identifies that ***'substance of the rights'*** of the parties to the transaction will essentially drive a company to the first or second category. It further points out that evaluation of marketing intangibles itself is a difficult exercise:

> *"It can be difficult to determine what these expenditures have contributed to the success of the product.[….] For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. […]* ***More fundamentally****, in* ***many cases higher return derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditure****. The* <u>*actual conduct of the parties over a period of years should be given significant weight in evaluating the return attributable to marketing activities*</u>*"*

It can be observed from the above paragraph that the OECD in its original guidelines gave us a glimpse of how difficult it is going to be for us in the future in determining the value of marketing intangibles. In other words, the guideline highlighted the importance of AMP expenditure and its contribution in making a product a success as well as expressed uncertainty in devising a proper methodology to determine what value of that AMP expenditure are attributable to the success of the product.

2.3.1. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (2010):

The OECD in its revised Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (2010) has discussed the role of intangibles in the area of transfer pricing. It distinguishes commercial intangibles in to the following two types:

- Trade Intangibles, and
- Marketing Intangibles.

The revised OECD guidelines brought patents, copyrights, industrial design and other easily transferrable intangibles under the ambit of Trade Intangibles whereas trademarks and trade names have been brought under the ambit of Marketing Intangibles. [para 6.3 of the OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administrators]

As per the revised OECD guidelines, AMP expenditure, just like R&D expenditure, can be recovered by increasing the price of the product. The part of AMP expenditure which was not recovered from the direct selling of the product will go to create marketing intangible which can be recovered by charging royalties [para 6.7 of the OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administrators]

2.3.2 Comparability Analysis:

Unlike the original OECD guidelines, the revised TP guideline (2010) is very clear on the method to be applied in determining the value of intangible i.e., through identifying proper comparables. It further states that for the purpose of determining arm's length price of an intangible, the perspectives of both the transferor and transferee must be taken in to account. That is, separate examinations should be made to find out at what price comparable independent transferor would be willing to transfer the property as well as to find out whether comparable independent transferee would be willing to pay such a price given the value and the usefulness of the product. It must also be looked in to whether the transferee would still be interested in closing the deal if he has to make further investment or incur other expenditure to use the licensed product.

As per the revised OECD guidelines, the above said test is important to ensure that the associated enterprise is not paying a huge amount of money for purchasing the property of limited value. Also, usefulness of the property should be taken in to consideration when determining the comparability. [para 6.15 of the OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administrators]

2.3.3 Marketing Activities Undertaken by Enterprises not owning Trademarks or Trade names [para 6.36 to para 6.39 of the OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administrators]

The revised OECD guidelines addresses the issue of marketing activities undertaken by an enterprise not owning the trademark in twofold:

- Whether marketer should be compensated for the marketing service it provides to another company?

or

- Whether the marketer is entitled to a return on marketing intangible above a normal return on marketing activities? And How the return attributable to marketing activities can be identified?

Issue #1: Whether marketer should be compensated for the marketing service it provided to another company or whether the marketer is entitled to a return on marketing intangible above a normal return on marketing activities?

The OECD says that in order to determine whether the marketer is entitled to a return or not, one should first assess the rights and obligations between the parties. If the distributor merely acts as an independent agent there is no adjustment (or share in any return attributable to the marketing expenditure) required as the distributor is entitled for reimbursement for all the expenditure it incurred from the owner of the brand. On the other hand, when the distributor actually bears the cost of marketing activities (i.e., there is no arrangement for the owner to reimburse the expenditure), the issue basically is to find out to what extent the distributor is able to share the potential benefits from such activities. In general, it basically depends on the ***substance of the rights of that party.***

For example, a distributor may have the ability to obtain benefits from its investments in developing the value of the trademark from its turnover and market share where it has a long term contract of sole distribution rights for the trademarked product. In such cases, the distributor share of benefits should be determined based on what an independent distributor would obtain in comparable circumstances. In some cases, when a distributor bears extraordinary marketing expenditure beyond what an independent distributor with similar attributes might incur for the benefit of its own distribution activities. The distributor in such cases must obtain an additional return from the owner of the trademark, perhaps through a decrease in the purchase price of the product or reduction in the royalty rate.

As far as **Issue #2** is concerned, that is **how to determine the return attributable to the marketing activities**, the OECD says it is very difficult to quantify the benefit contributed by the AMP expenditure. The OECD ***recognizes a scenario - where a new trademark or newly introduced trademark in particular market will have no or little value in that market and its value can change over the years as it makes an impression on the market. On the other hand, the OECD also recognizes the other scenario where the higher returns derived from sale of trademarked product may be owing to the unique characteristic of the product or***

its high quality as to the success of advertising and other promotional expenditures.

In these circumstances, the OECD concludes by stating that the actual conduct of the parties over a period of significant number of years should be given weight in evaluating the return attributable to the marketing activities.

2.4 Maruti Suzuki India Ltd. Vs ACIT

The concept of Marketing Intangibles entered into the Indian Transfer Pricing bandwagon rather quickly than expected. It was in the case of Maruti Suzuki India Ltd. Vs ACIT, the Delhi High court vide writ petition no.6876/2008 elaborately analysed the concept and set forth several guiding principles to find out whether the marketing expenditure incurred by the Indian AE significantly promotes the brand of its foreign AE.

The short facts of the case are that Maruti Udyog Ltd. (Indian AE) entered in to a license agreement with a Japanese automobile giant, Suzuki Ltd. As per the agreement, Maruti is allowed to use all the intangibles of Suzuki Ltd. (Such as know-how, patent, trademark, trade secrets and all other intangible assets) for a lump sum royalty payment of 500,000,000 Japanese yen apart from the running royalty which should be paid every year along with a condition that Trademark logo 'M' should be changed to 'S' in all the products manufactured by Maruti. Also, the word 'Suzuki' should be piggy backed to the word 'Maruti' in the rear side of all the vehicles Maruti manufactures.

The Tax department initially thought that it amounted to transfer of ownership of the trademark 'M' to Suzuki and passed an order disallowing the entire AMP expenditure of Rs.4092 crores incurred by Maruti during the financial year 2004-05 along with a cost plus mark-up of 8%. However, during the course of the writ petition, the tax department after realizing that there was no such transfer of ownership as Maruti was still the owner of the logo 'M', passed a revised order stating that changing of logo from ‘M’ to ‘S’ and piggy backing of the word ‘Suzuki’ after the word ‘Maruti’ in the rear side of the vehicles helped the lesser known brand ‘Suzuki’ to establish a goodwill in India without any effort whatsoever. The tax department also stated that the piggy backing of the word ‘Suzuki’ impaired the brand value of ‘Maruti’ in India and reinforced the value of the brand ‘Suzuki’. Hence, the department disallowed a sum of Rs.198 crores from the AMP expenditure of Maruti which according to it should have been reimbursed by Suzuki.

2.4.1 Guiding Principles:

It is must be noted here that the Delhi High Court while propounding the guiding principles to determine whether the Indian AE should be reimbursed or not by the foreign AE, incorporated both US regulations and OECD guidelines.

The Hon’ble High Court supported the ‘Bright-Line Test’ propounded by the US Tax Court and came up with an innovative solution to address AMP expenditure incurred by the Indian AE. The Hon’ble court first distinguished the ‘tested party’ as the Indian AE, and then differentiated the expenditure incurred by the Indian AE as discretionary expenditure and mandatory expenditure. It would be appropriate for us to know about the different concepts put forth by the Hon’ble court before going in to the guiding principles.

2.4.1.1 Independent Party

The Indian transfer pricing regulations as well as various judicial pronouncements have now made it clear that the ‘tested party’ must necessarily be the assessee and not the foreign AE. Independent party or an agent is a party that completely operates and manages the affairs of its business without any intervention or supervision of owner of the product.

2.4.1.2 Indian AE

Indian associated enterprise is a party that is a subsidiary or a joint venture or related by any other means to a company situated abroad. As per the transfer pricing regulations all the transaction between the Indian AE and foreign AE should be at arm's length range.

2.4.1.3 Discretionary Expenditure or Discretionary use of foreign AE's Logo

Discretionary expenditure means that there is no arrangement between the associated enterprises to promote the brand of foreign AE in India by way of AMP expenditure or by using the foreign AE's logo in the products which are sold in India.

2.4.1.4 Mandatory Expenditure or Mandatory use of foreign AE's Logo

Mandatory expenditure means that there is an arrangement between the associated enterprises to promote the brand of the foreign AE in India by way of AMP expenditure or by mandating the Indian AE to use the logo of foreign AE.

Principle No.1: ***Independent party*** uses the **logo** of unrelated foreign entity. No payment or reimbursement is required by the foreign AE irrespective of whether the use of logo is discretionary or obligatory.

Principle No.2: Indian AE **uses the logo** of foreign AE ***discretionarily***. No payment or reimbursement is required by the foreign AE if the use of logo is discretionary, but the income arising from the use of logo should be at arm's length i.e., the AMP expenditure spent by the Indian AE should be proportionate to the income it gets and also should be similar to what the independent comparable would have spent in the similar circumstances. Bright-line test can be applied to find out the Arm's length range of the AMP expenditure.

Principle No.3: Indian entity **uses the logo** of foreign AE ***mandatorily***. Foreign AE must make appropriate payment to the Indian entity for the benefit it derived in the form of marketing its intangibles through the Indian AE.

Principle No.4: The income derived from the above transaction should be at arm's length. All factors must be considered in determining arm's length price and suitable adjustments should be made to neutralize the differences. The rights and obligations of both the parties should be looked in to while making the adjustments.

<u>Principle No.5:</u> ***Independent party*** uses the logo of foreign entity and **incurs AMP expenditure**. The AMP expenditure incurred by the independent party need not be compensated by the foreign entity ***unless agreed by the parties***.

<u>Principle No.6:</u> Indian entity uses the logo of AE ***discretionarily*** and **incurs AMP expenditure**. The discretionary AMP expenditure incurred by the Indian entity need not be compensated by the AE so long as the expenditure incurred by the Indian entity does not exceed the expenses incurred by the independent party (comparables) placed in a similar situation. If the discretionary AMP expenditure is more than the AMP expenditure incurred by the comparables, the AE should compensate the entity for the benefit it obtained in the form of brand building, increased awareness of the brand, etc.

<u>Principle No.7:</u> In case, the Indian entity needs to be compensated by the AE for the discretionary AMP expenditure, then the TPO should calculate the arm's length price of the transaction between the AE and Indian entity after making suitable adjustments for all rights and obligations of the parties, including the benefit the AE derived from the marketing intangibles.

<u>Principle No.8:</u> Indian entity uses the logo of AE **discretionarily as well as mandatorily** and **incurs AMP expenditure**. If the AMP expenditure is more than the comparables' AMP expenditure, the TPO before making any decision should try to take the comparable companies with their expenditure.

<u>2.4.2 Comments:</u>

The decision of Delhi High Court in the above mentioned case is an insightful one, in the sense that, it appreciated and incorporated the method followed by a foreign country i.e., US tax courts and proposed an equally appreciable principles to be followed while applying the said method after giving due recognition to the regulations formulated by OECD. It is noteworthy to mention here that the concepts coined by the Hon'ble Court such as *Mandatory use of a brand name* and *Discretionary use of a brand name* to decide whether the AMP expenditure of the Indian AE increased the brand value of its foreign AE are widely appreciated and applied across the globe.

Despite the positives, the decision of Delhi High Court has certain short comings. The decision of the Delhi High Court was not a decisive one but set forth a platform for a new issue altogether. The short comings are:

- It did not prescribe a proper methodology to arrive at the comparables
- It prescribed only that suitable adjustments should be made but did not address how an adjustment could be made when the comparable is already paying a royalty for using the brand name or when the tested party is not paying any royalty. Similarly, what happens when the foreign AE has several AEs in India whereas the independent comparable selected by the TPO is a sole Indian AE.
- Similarly, it did not address how a proper adjustment should be made when the independent comparable selected by TPO is regulated by a short-term agreement whereas the tested party is regulated by a long-term agreement.
- Also, the Delhi High Court did not address the issue of whether the direct selling expenditure should also be brought under the ambit of AMP expenditure

The above undecided set of issues has lead to a new class of issues in the Indian Transfer Pricing domain. Furthermore, a SLP was filed in the Supreme Court against the order of Delhi High Court in the abovementioned case and the Supreme Court has remanded the matter back to the TPO with a direction to decide the issue without being influenced by the order of Delhi High Court in any manner.

This decision of Supreme Court brought an altogether whole new debate as to whether it had dismissed the decision of Delhi High Court or not. The Indian Judiciary has yet again passed an order which can be speculated and interpretated in more than one way!

The Indian Revenue Department has slapped demands on this issue for a number of MNEs situated in India and the assesses have also responded by litigating this issue beginning from questioning the very jurisdiction of the TPO u/s 92 of the Act to that of the decision of Delhi High Court as being not good in law. This prompted the ITAT to form a Special Bench to decide the issue. Hence, a special bench was constituted in the case of ***L.G.Electronics Vs CIT*** and as many as 22 MNEs joined as interveners. We now proceed to analyze the decision of Delhi Special Bench in detail below.

2.5 L.G. Electronics Vs ACIT [(2013) 140 ITD 41 (Del)(SB)]

The Delhi Special bench analysed the concept of brand promotional expenditure and its applicability from almost all angles. It has elaborately discussed the legal character and the factual position of AMP expenditure. Let us now see the gist of the decision of the special bench issue by issue.

2.5.1 Jurisdiction:

The contention of the assessee was twofold.

(i)That there was no ***transaction*** between the assessee and its foreign AE much less an ***international transaction***.

(ii)It was the case of the assessee that the TPO did not have jurisdiction as per Section 92 of the Act.

(iii)the TPO cannot assume jurisdiction to entertain a particular transaction especially when the assessing officer had not referred that particular transaction to him.

The bench held that there need not be any express arrangement between the AEs to be under the ambit of transaction. It is enough if there was any implied understanding between the AEs to bring it under the ambit of Section 92B of the Act. Secondly, with respect to the contention regarding international transaction, the special bench held that the scope of term 'international transaction' has been expanded by the Finance Act, 2012 with effect from 01.04.2002 and moreover it had expressly included AMP expenditure in its ambit. The special bench also dismissed the contention of the assessee that the TPO had passed the order before the retrospective amendment (Finance Act, 2012) and hence, that amendment will not be applicable. With regard to the third contention also, the special bench held it against the assessee on the ground that once a matter has been referred to the TPO, he is free to take cognizance of all transaction of that particular assessee.

2.5.2 Economic Ownership Vs Legal Ownership

It was the contention of the assessee that it became the owner of the brand by virtue of being a developer – assister rule since it spent more on promotional expenditure than its foreign AE. However, the special bench refused to accept this contention on the ground that the principle of economic ownership is basically flawed since anyone, even a distributor, can become an owner of the brand by spending more and moreover, it is only the legal character of the product/brand which will hold good for the purpose of law.

2.5.3 Cost/Value of transaction:

The special bench also dismissed the other ground of the assessee that 'Bright Line Method' is not a prescribed method under the Indian TP regulations. The assessee supported his argument by contending that the words 'any other method' was included only later and will not be applicable to the assessee's case. However, the special bench held that 'Bright-Line Method' is nothing but the extension of 'Cost-plus Method' and non-mentioning of that name in the TPO order, will not take away the character of the cost-plus method.

Moreover, if the assessee fails to show where to draw the line or other cogent ways for determining the cost/value of international transaction, it is for the TPO to find out the cost/value by applying some method.

Besides, the special bench also laid down a list of 14 questions which should be considered while deciding the cost/value of the international transaction. They are as follows:

"1. Whether the Indian AE is simply a distributor or is a holding a manufacturing licence from its foreign AE?

2. Where the Indian AE is not a full-fledged manufacturer, is it selling the goods purchased from the foreign AE as such or is it making some value addition to the goods purchased from its foreign AE before selling it to customers?

3. Whether the goods sold by the Indian AE bear the same brand name or logo which is that of its foreign AE?

4. Whether the goods sold bear logo only of foreign AE or a logo which is only of the Indian AE or is it a joint logo of both the Indian entity and its foreign counterpart?

5. Whether Indian AE, a manufacturer, is paying any royalty or any similar amount by whatever name called to its foreign AE as a consideration for the use of the brand/logo of its foreign AE?

6. Whether the payment made as royalty to the foreign AE is comparable with what

8. Where the Indian AE is using technical know-how received from the foreign AE and is paying any amount to the foreign AE, whether the payment is only towards fees for technical services or includes royalty part for the use of brand name or brand logo also?

9. Whether the foreign AE is compensating the Indian entity for the promotion of its brand in any form, such as subsidy on the goods sold to the Indian AE?

10. where such subsidy is allowed by the foreign AE, whether the amount of subsidy is commensurate with the expenses incurred by the Indian entity on the promotion of brand for the foreign AE?

11. Whether the foreign AE has its presence in India only in one field or different fields? Where it is involved in different fields, then is there only one Indian entity looking after all the fields or there are different Indian AEs for different fields? If there are different entities in India, then what is the pattern of AMP expenses in the other Indian entities?

12. Whether the year under consideration is the entry level of the foreign AE in India or is it a case of established brand in India?

13. Whether any new product is launched in India during the relevant period or is it continuation of the business with the existing range of products?

14. How the brand will be dealt with after the termination of agreement between

2.5.5 Selection of Comparables

The special bench has strongly condemned the action of TPO for summarily rejecting the comparables submitted by the assessee. The assessee had submitted that Samsung Inc. should also be taken as a comparable but the revenue cherry picked the comparables which had comparatively less AMP expenditure. It remanded the matter back to the TPO with direction to give due opportunity to the assessee.

Most importantly, the special bench devised a methodology to select the comparables. It indirectly criticized the decision of the Delhi High Court in the case of Maruti Suzuki Vs CIT by stating that the comparable should be an independent domestic company and not a subsidiary of a foreign entity. It substantiates its stance by stating that comparing the transaction of the assessee with the subsidiary of the foreign entity will not amount to a comparable uncontrolled transaction since the expenditure incurred by the subsidiary will be controlled or regulated by its parent company abroad. Hence, it concluded by stating that a comparable should be an independent domestic company.

2.5.6 Direct Selling Expenditure should be Excluded:

One of the important contentions of the assessee and the interveners was that the TPO had erred in including selling expenses in the total AMP expenses for the purpose of determining ALP. The special bench held that AMP expenses refer only to advertising, marketing and publicity expenses. It also held that a divider needs to be placed between the expenses for the promotion of sales on one hand and expenses in connection with the sale on the other hand.

<u>2.5.7. Whether the decision of Delhi high Court in the case of Maruti-Suzuki Vs ACIT still holds good?</u>

The other important issue discussed by the special bench was whether the decision of Delhi High Court was overruled by Supreme Court through the SLP filed by Maruti-Suzuki[4].

The special bench held that the decision of Delhi High Court in the case of Maruti-suzuki still holds good in law since the Supreme Court only directed the TPO to not to apply the principles laid down by the HC in ***<u>that</u>*** case alone. Moreover, the Supreme Court did not expressly overrule (or hold that it is bad in law) the decision of Delhi High Court in its one page order, so it cannot be assumed to be overruled.

<u>2.5.8 Comments:</u>

This decision of the special bench is much more conclusive and decisive than the decision of Delhi High Court in the case of Maruti-Suzuki Vs ACIT. It has settled preliminary issues like whether the *TPO has <u>jurisdiction</u>* <u>u/s 92</u>, whether there exists a <u>*transaction* u/s 92 of the Act</u> and whether there was an <u>*international transaction*</u> u/s 92 of Act. Also, it agrees with the view of Delhi High Court that the AMP expenditure in excess of the arm's length range helps to promotes the brand of the foreign AE and that the Indian AE should necessarily be compensated by the foreign AE. Thirdly, it also dissents with the developer-assister rule and economic ownership of the brand concept on the ground that nobody can become an owner of a brand by merely splurging money to promote a brand that did not legally belong to him.

Likewise, it settled once and for all the issue of whether to include selling expenditure in the AMP expenditure. in favour of the assessee.

However, even this elaborate decision could not put a full stop to the brand promotion band issue. In fact, this decision laid a platform for more confusion through ***<u>The 14 Factors</u>*** in selecting the comparables and making adjustments. Each

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4 *Maruti Suzuki India Ltd. VS. Addl. CIT [(2011) 335 ITR 121 (SC)]*

of the 14 factors recommended by the Special Bench will be put under a scanner in the near future and there will be more and more bargain from both the sides (i.e., from the assessee as well as from the department) with respect to the adjustments to be made in the comparable companies profits to be comparable with the tested party.

In fact, a glimpse of what is about to follow has already been shown in this case itself when the assessee raised a stance that its higher profit margin when compared to that of its comparable companies proved that it had received subsidy from its parent company in the form of lower purchase price and accordingly, an adjustment should be made in the arm's length range fixed by the TPO to effect the subsidy it received from its parent company whereas, the special bench refused to accept the stance of the assessee and held that the assessee should prove beyond doubt that it has received subsidy from its parent company in order to make an adjustment in the arm's length range fixed by the TPO. The difficulty here is, it becomes almost impossible in most of the circumstances to prove it with documentary evidences that the Indian AE had indeed received some subsidy when the product it purchases is unique like a car or an electronic appliance (since no car or an electronic appliance is similar in technology or spare parts wise). The same logic applies for all the 14 factors laid out by this special bench.

The irony here is that the special bench held that even an implied arrangement (without any documentary evidence) is enough for the TPO to take cognizance of brand promotion, but it is up to the assessee to prove beyond doubt (with as many supporting documents as possible) to make any adjustment in the arm's length range fixed by the TPO.

2.6 The Post Effects of L.G.Electronics Vs ACIT:

Following the decision of special bench in the case of L.G.Electronics Vs ACIT, the various Tax Tribunals have remanded back many of the pending cases relating to AMP expenditure to the file of TPO with specific directions to follow and apply the principles laid down by the Delhi Special Bench. Let us now see some of the recent cases decided by the ITAT on the above lines:

2.6.1 Glaxo Smithkline Consumer Healthcare Limited Vs ACIT [ITA 1148/chd/2011]

The issue of this case is identical to that of the abovementioned cases. However, in this case the assessee was able to prove that it received subsidy from its parent company for promoting its brand through advertising, marketing and promotion. The subsidies were in the form of service charge paid to the selling agent, sales promotion, discount on sales, market research expenditure and selling and distribution expenditure. The ITAT while remanding the matter in the light of the decision of the Delhi Special Bench to the TPO held that expenses inextricably related to sales and not related to brand promotion expenditure should be excluded from AMP expenditure.

Similarly, the ITAT has passed similar orders in the case of Canon India Pvt. Ltd Vs ACIT[5] and Panasonic Sales & Services India Ltd VS ACIT[6]. That is, the ITAT has held that these subsidies will significantly increase the quantum of non-routine expenditure and ought to be reimbursed by the foreign AE.

2.6.2 Ford India Ltd Vs DCIT [I.T.A. No. 2089/Mds/2011]

In this case, the TPO penalized the assessee in a dual way. First, he held that 1% of the assessee's total sale value should be reimbursed by its foreign AE for the value of brand promotion enjoyed by it. Secondly, he calculated the arm's length

[5] *ITA Nos. 4602/Del/ 2010, 5593/Del/2011 & 6086/Del/2012*
[6] *I.T.A. No. 1911/Mds/2011*

price of the AMP expenditure incurred by the assessee using Bright-Line test method. The ITAT has rightly deleted the 1% addition made by the TPO and remanded the matter back to the file of TPO to decide the second issue in line with the decision of Delhi Special Bench.

Another interesting aspect of this case is that the assessee claimed an expenditure of Rs.14.84 crores as product design expenditure. Apparently, there was a collaboration agreement between the assessee and its foreign AE and as per the agreement all the Technical Know-how invented by the R&D department of the assessee would belong only to the assessee. Disregarding that agreement, the ITAT held that the assessee was eligible only for 50% of the total product design expenditure on the ground that there was no restriction on the foreign AE to use the R&D developed by Indian AE. Also, in the long run the foreign AE would be using the technical know-how invented by assessee for the enhancement of its product.

2.6.3 Remarks:

The trend of remanding the matter back to the file of TPO clearly underlines the fact that there is a need for careful consideration on selection of comparable companies to ascertain the arm's length range of the AMP expenditure. It is also important for the taxpayer to route all the promotional expenses through a proper channel in a structured way. i.e., it is pertinent for the assessee to have in place agreements/documents to claim adjustments to the arm's length range fixed by the TPO as well as for selecting the proper comparable companies.

3. Valuation of Intangibles

Now that the Delhi High Court and the Special Bench have made it abundantly clear that AMP expenditure incurred by the Indian AE in excess of the arm's length range should be reimbursed by the foreign AE, it would not be irrelevant to analyse other prescribed methods for evaluating intangibles. Apart from that, the Delhi Special Bench also made a specific remark that when the assessee did not apply any other method to find out the ALP of the AMP expenditure it is for the TPO to formulate a method to find out the ALP.

The Chamber of Tax Consultants in its practical guide to Indian Transfer Pricing have prescribed the following five methods for the valuation of intangibles. They are as follows:

3.1 CUP Method: This method can be adopted to determine the value of intangibles when there are previous similar independent transactions with complete access to all relevant agreements. This method involves identifying all the comparables and thereafter deleting some of the comparables which are improper. Adjustments can also be made in the selected comparables in order to arrive at the proper figure. However, it becomes impossible to apply this method when there are no previous similar transactions/comparables available. In other words, this method cannot be applied in valuing the brand equity or intangible value of unique product since there will be no comparables.

3.2 Income Based Methods (IBMs): The second method for valuation of intangibles is IBMs. This method can be applied by determining the future income of the intangible. Future income of the intangible is nothing but the amount of income which could be generated by that particular intangible. The second step and third step in determining the value of the intangible are estimating the life cycle of that particular intangible to provide suitable discounts every year to arrive at the present value.

The main drawback of this method is to estimate the correct future value and the life cycle of the intangible since both of them are purely subjective.

3.3 Super-profit Method: Super profit method is by far the simplest method to determine the value of the intangibles. It is calculated by deducting the value of the goods without any intrinsic intangible value from the value of same goods with intrinsic intangible value. In order to apply this method, the base commodity should be identical.

3.4 Replacement Cost Method: This method tries to determine the value of time and cost that could be incurred to replace the asset in present's day value. This method cannot be applied to many of the cases as it has very limited scope, such as, IP rights cannot be replaced as it is prohibitive in law. This method could bring accurate value of tangible assets but not intangible assets.

3.5 Binomial or Non-Traditional Methods: Non-traditional methods determine the value of intangibles based on contingencies. It records both favorable and unfavorable contingencies and will be evaluated based on any of the above mentioned methods. It is important under this method to not to leave out any contingencies as it might vary the results drastically.

4. Concluding Remarks:

The ruling of Delhi High Court and the Delhi Special Bench make it very clear that not all AMP expenditure incurred by the assessee will be considered as an allowable expenditure in India. Hence, it is also clear that the assessee cannot dispute the very disallowance of AMP expenditure on preliminary grounds such as that there is no promotion of brand of the foreign AE by the assessee. However, the issue lies in determining a proper methodology to find out the arm's length price of that AMP expenditure. The Delhi Special Bench did not conclude that Bright-Line test method is the only method which should be applied to arrive at the arm's length price of the AMP expenditure but laid it open to the assessee as well as the TPO to apply *any method* to find out the arm's length price. The Chennai ITAT also recognised the difficulty in selecting proper comparables in determining the arm's length price of the AMP expenditure in the case of Ford India Vs ACIT[7].

[7] Supra

A reasonable result cannot be obtained without making suitable adjustments with regard to the nature of the expenditure, economic condition of the market, level of competition in the market, potential of the product in the market, nature of the benefits received from the foreign AE in determining the arm's length price of AMP expenditure. Thus, it is understood that it requires robust documentation on the part of the assessee to prove each single point of the adjustments it makes in calculating the arm's length price of the AMP expenditure it has incurred.

It requires more than 'who is doing what' in a company. The process of identifying the portion of success contributed by the AMP expenditure should be the starting point in determining the arm's length price of the AMP expenditure because as stated by OECD guidelines the increase in sales of the product may be because of other factors also such as unique nature of the product, quality or several other things. More importantly, specific demarcation is required with regard to the direct selling expenditure i.e., expenditure which are directly related to sales such as sales commission etc. since those are specifically allowed by the Special Bench in favour of the assesee.

Strategic readjustments are required on the part of the MNEs before hand in the light of the special bench decision while determining the role of AEs in promoting the brand value to be on the beneficial side of the decision.

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