Delhi Tribunal overturns transfer pricing adjustment for excess advertising expenses in the case of a distributor

Executive summary

This Tax Alert summarizes a recent ruling of the Delhi Bench of Income-tax Appellate Tribunal (Delhi Tribunal) in the case of an assembler and distributor of motor vehicles (Taxpayer) vs Additional Commissioner of Income-tax (Tax Authority) on the issue of a transfer pricing adjustment for “excessive” advertising, marketing and promotional (AMP) expenditure incurred by the Taxpayer during Assessment Year 2008-09.

The transfer pricing issue before the Delhi Tribunal was whether the Taxpayer needs to be compensated under arm’s length conditions for its promotional efforts that resulted in the Taxpayer incurring AMP expenses. The Tax Authority had alleged that as the Taxpayer incurred AMP expenditure that was more than what comparable uncontrolled companies had incurred, the Taxpayer was providing a service to its associated enterprise (AE) of enhancing the value of the latter’s marketing intangibles. Before addressing the above issue, the Tribunal was also required to deal with the issue of whether the decision of the Special Bench (SB) of the Tribunal in the case of LG Electronics India Pvt Ltd1 (LG Electronics) laid down a binding precedent for the Taxpayer.

As the Taxpayer was able to distinguish its facts from that considered by the SB in the case of LG Electronics, the Tribunal held that the ruling of the SB would not apply to the Taxpayer wherever facts and law so demand. Thereafter, in accordance with the ruling of the SB, the Tribunal held that “excess” AMP expenditure incurred by the Taxpayer constituted an international transaction and that the “bright line test”
could be used to measure whether the expenditure was excessive or not. However, considering the facts, the Tribunal accepted the Taxpayer's argument that additional compensation for its non-routine functions need not necessarily come by way of a service fee but could also be embedded into the import price of goods. The Tribunal held that unlike a manufacturer, a distributor’s compensation was reward based. Thus, since the Taxpayer in the instant case was earning robust margins and its contract with its associated enterprise explicitly stated its roles and responsibilities and remuneration model, the Tribunal held that its remuneration for non-routine functions was already embedded into the price of goods it imports from its AEs.

Facts
The Taxpayer is a wholly owned subsidiary of its foreign parent which was engaged in the manufacture, marketing and distribution of motor vehicles and related spare parts and accessories. The Taxpayer has entered into an agreement with its foreign parent, obtaining a right to sell motor vehicles manufactured by the foreign parent in the Indian territory. The Taxpayer in turn undertook the responsibility of sales promotion and advertising to ensure full utilization of market potential of foreign parent's products. The Taxpayer also undertook the responsibility to provide after sales support services to customers. The agreement did not have fixed tenure and would continue to be in effect until it was cancelled by either party.

The foreign parent allowed the Taxpayer to use its brand name and trade marks in India, without any restriction. No royalty was paid by the Taxpayer for such use.

During transfer pricing audit, the Transfer Pricing Officer (Tax Authority), by applying the so called “bright line test (BLT),” alleged that the Taxpayer’s AMP expenditure was excessive. The Tax Authority compared the AMP expenditure to sales ratio of the Taxpayer to the average of the same ratio of companies considered comparable by him to determine the quantum of “excessive” or “non-routine” AMP expenditure incurred by the Taxpayer. The Tax Authority in his order held that the Taxpayer should have received a reimbursement for the “excessive” or “non-routine” AMP expenditure in addition to a mark-up of 15% on the “excessive” AMP expenditure.

The Taxpayer filed objections before the Dispute Resolution Panel (DRP) who upheld the Tax Authority’s order. However, the DRP directed the TPO to exclude from the AMP calculation, the amounts pertaining to the after sales support costs and salesman bonus.

Following the DRP order, the Taxpayer filed an appeal before the Delhi Tribunal. It also filed an application for intervention before the SB in the case of LG Electronics. The application was subsequently withdrawn by the Taxpayer.

Ruling of the Delhi Tribunal
On applicability of judicial precedence
The instant case was being argued in the shadow of the SB of the Delhi Tribunal ruling in the case of LG Electronics. The Taxpayer had argued that the order of the SB was based on facts that were different from that in the Taxpayer’s case, thus, the adjudication should be made on the basis of its own fact pattern. The Tribunal ruled that unlike Acts of Parliament, judicial rulings are specific to the facts that are argued before a court. The decision in a particular judicial ruling can be considered to be a judicial precedence only in cases where the facts are the same vis-à-vis this ruling.

Based on the above principles, the Tribunal held that the Taxpayer could argue its case in detail and that the applicability of the SB ruling in the case of LG Electronics would be decided based on the facts of the case presented by the Taxpayer.

AMP expense as an international transaction
The Taxpayer had argued that AMP was a function that it performed as part of its roles and responsibilities as a distributor and that it was not an international transaction that needed to be disclosed separately. The Taxpayer had placed its intercompany agreement on record and argued that advertising and sales promotion activity was its responsibility as per the contractual terms of the agreement between the Taxpayer and its AE.
The Tribunal held that the Taxpayer had assumed a greater role and responsibility vis-à-vis the comparable companies and performed non-routine advertising marketing functions. This was supported by the fact that after applying the bright-line test the AMP expenditure of the Taxpayer exceeds the AMP to sales ratio of the comparable companies. The Tribunal also made a detailed reference to the industry overview of the automobile sector forming part of the Taxpayer’s transfer pricing documentation and concluded based on the same that the Taxpayer performed the function of sales promotion and advertisement in order to increase its share in a highly competitive market.

While the Tribunal accepted the alternative arguments of the Taxpayer that as a distributor it is necessarily required to incur expenditure for warehousing, sales promotion and even advertisement, in view of the SB ruling in the case of LG Electronics, the Tribunal held that the excess AMP expense incurred by the assessed was an international transaction.

Validity of the Bright Line Test
The Tribunal upheld the use of the BLT in this case based on the SB ruling in the case of LG Electronics and also that the BLT is an internationally accepted tool both in developed and developing countries for determination of routine AMP expenses.

Consistency of FAR profile and remuneration model
The Taxpayer further argued that even though it had taken greater responsibility and function as compared to what a routine distributor would take up in a third party scenario, it was adequately compensated for undertaking the non-routine function as was evident from the fact that the gross margin as well as the net margin earned by the Taxpayer was significantly more than what was earned by the companies used as comparable by the Tax Authority to compute the routine AMP expenditure that a third party distributor would undertake. Hence, the Taxpayer argued, no additional compensation was warranted for the non-routine AMP expenditure.

In response to the Taxpayer’s argument that its compensation for non-routine functions was built into the price of goods sold to it, the Tribunal held that even though the SB in the case of LG Electronics had not accepted the argument that the compensation for additional function was embedded in the price of imports, the said decision was made in the context of a licensed manufacturer as well as inadequate evidence to support the same.

However, in the present case, the facts being considered pertained to a distributor whose remuneration model was significantly different from that of the licensed manufacturer. A licensed manufacturer necessarily employs greater assets and is exposed to a higher risk vis-à-vis a distributor and has a higher potential of profit/loss consequently higher risks than a distributor. A distributor on the other hand operates with lesser risk and the remuneration model is reward-based. Further, the Tribunal noted that the intercompany agreement explicitly mentions that the goods would be sold to the Taxpayer at a price that would ensure the recovery of all costs and an appropriate profit for the functions performed by the Taxpayer.

It also further noted that the ratio of excess AMP to sales in the case of Taxpayer was minimal compared to the ratio of excess gross margin to sales and net margin to sales earned by the Taxpayer as compared to those earned by the companies considered comparable by the Tax Authority. Thus, both the gross margin and the net margin earned by the Taxpayer was already significantly more than what was earned by the routine distributors considered comparable by the Tax Authority to compute the routine level of AMP expenditure.

It also concurred with the Taxpayer’s argument that the profit that it had earned over and above that of the routine distributors was more than the transfer pricing adjustment proposed by the Tax Authority. Based on the above, the Tribunal accepted the Taxpayer’s argument that the compensation for its non-routine functions was already built into the pricing of the products that it purchased from its AEs and thus no additional compensation was warranted.
Impact

Transfer pricing aspects of marketing intangibles have been the focus of the Indian tax authority for the last few years. The OECD Transfer Pricing Guidelines (the Guidelines) recognize that difficult transfer pricing problems can arise when marketing activities are undertaken by enterprises that do not own the trademarks they are promoting. According to the Guidelines, the analysis requires an assessment of the obligations and rights between the parties. The United Nations Transfer Pricing Manual (UNTPM) also states that marketing related activities may result in creation of marketing intangibles depending on facts and circumstances of each case. The Indian chapter of the UNTPM however is more explicit when it states that an Indian AE needs to be compensated for intangibles created through excessive AMP expenses and for bearing risks and performing functions beyond what an independent distributor with similar profile would incur or perform.

This Tribunal ruling, while acknowledging the precedential value of some of the principles set by the SB in the case of LG Electronics, also recognizes that taxpayers may be able to distinguish their case based on specific facts. Given the intense factual nature of transfer pricing issues, taxpayers may therefore need to give due consideration to facts while applying judicial precedents.

The Tribunal ruling, similar to the SB’s ruling in the LG Electronics’ case, relies extensively on the facts particularly relevant to the Taxpayer in this case and therefore its impact on other taxpayers may need to be examined based on their specific facts. In light of the ruling, it would be useful for multinational enterprises with Indian affiliates to review their intra-group arrangements relating to sales and marketing and use of trademarks/brand names to assess the impact of the ruling.

Endnote

1. TS-11-ITAT-2013(Del)-TP.
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