India’s Delhi Tribunal rules on transfer pricing issues regarding AMP expenses, software support services and CAPM risk adjustments

Executive summary
This Tax Alert summarizes a recent ruling of India’s Delhi Income-tax Appellate Tribunal (Tribunal).

The issues before the Tribunal were the appropriateness of a transfer pricing (TP) adjustment made by the Transfer Pricing Officer (TPO) for the Financial Year (FY) 2006-07 with regard to “excessive” advertising, marketing and promotional (AMP) expense incurred by the Taxpayer in its distribution activity and the level of mark-up on costs for provision of software development services and administrative and market support services.

The TPO alleged that the AMP expenses incurred by the Taxpayer benefitted the AE by enhancing the value of the marketing IP belonging to the AE, for which the Taxpayer needed to be appropriately compensated under arm’s length principles. A TP adjustment of approximately INR 1.79 billion was made for this transaction. The Tribunal primarily relied on the decision of the Special Bench (SB) in the case of LG Electronics v ACIT ([TS-11-ITAT-2013(DEL)]) and distinguished the Taxpayer’s case from the Delhi Tribunal ruling in the case of BMW India Pvt. Ltd v ACIT ([TS-230-ITAT-2013(DEL)]). The Tribunal thereafter restored the matter back to the TPO for deciding the issue in light of factors outlined by the Special Bench in the case.
of LG Electronics (supra). It may be noted that the Special Bench had indicated 14 factors that needed consideration while dealing with the issue. In the facts of the case, the Taxpayer argued that it had been compensated by its AE as its group’s global TP policy required appropriate adjustments so that the Taxpayer earned an arm’s length return on sales. Such adjustments were affected by way of credit notes from the AE and should be considered as a form of compensation or subsidy for the “excessive” AMP expenses that Taxpayer had allegedly incurred. The Tribunal observed that while the compensation or subsidy received from the AE is a factor that needs consideration in light of the ruling in the case of LG Electronics (supra), the Taxpayer would need to specifically demonstrate a nexus between the adjustments made by way of credit notes and the AMP expense incurred by the Taxpayer and a conclusion on this matter cannot be reached by considering the overall operating profit margin of the Taxpayer.

The TP adjustment relating to provision of software development services (approximately INR 1.07 billion) and marketing and administrative services (approximately INR 78 million) primarily arose in view of a difference in selection of comparable data by the TPO. The Tribunal while restoring the matter back to the TPO for re-determination made significant observations regarding application of various quantitative and qualitative criteria for selection of comparable data. The Tribunal also recognized the need to make appropriate adjustment for risk differences between the Taxpayer and the comparable companies and acknowledged that the Capital Asset Pricing Model (CAPM) may be used for this purpose. The Tribunal proposed the appointment of independent experts by the Taxpayer as well as the TPO to determine the risk adjustment.

Detailed discussion

Background

The Taxpayer is primarily engaged in the distribution of telecom equipment, mobile phones and provision of telecommunication service in India. The Taxpayer also rendered software development, marketing and administrative support services to its group companies.

During the TP audit proceedings for FY 2006-07, the TPO challenged the TP analysis undertaken by the Taxpayer and accordingly made TP adjustments. The key issues and reasons for the TP adjustment were as follows:

Distribution segment (AMP expenses)

In its TP documentation, the Taxpayer concluded the arm’s length nature of its international transaction on the ground that its operating margin of 5% was higher than comparables operating margin of 1%. Although the TPO did not challenge the operating profit margins of the Taxpayer, the TPO contended that the Taxpayer had incurred AMP expenses in its sales and distribution activity that promoted and enhanced the value of marketing IP belonging to the AE. In the absence of any intercompany arrangement for undertaking such promotional activities, the TPO characterized this arrangement as provision of intra-group services by the Taxpayer that benefitted the AE. The TPO applied the so called “bright-line test” by comparing the average AMP/Sales ratio of the comparable companies (0.65%) with that of the Taxpayer (7.38%). The “excess” AMP was alleged to have been incurred for the benefit of the AE. The TPO thereafter applied a mark-up of 13.04% on the “excess” AMP expense to determine the quantum of TP adjustment as the remuneration the Taxpayer should have earned under arm’s length principles.

The Taxpayer contended that as per the group’s global TP policy, the compensation model of the Taxpayer is structured in a manner that the reimbursement of any “excess” AMP expenses is built into the intercompany pricing that allows the Taxpayer to earn an arm’s length operating margin. The Taxpayer mentioned that the credit notes received during the year from the AE, compensated the Taxpayer with respect to its AMP activities and ensured that its operating margin was higher than those of the comparables. The TPO rejected the Taxpayer’s contention on the grounds that it did not provide substantial evidence that the credit notes or subsidy received was toward the AMP expenses incurred by the Taxpayer.
Software development services
The Taxpayer rendered software development and coding services relating to documentation, testing, implementation and maintenance activities. For FY 2006-07, the Taxpayer concluded this transaction to be at arm’s length as the 7% margin on operating cost earned by the Taxpayer was within the permitted tolerance band margin of 10% earned by comparable uncontrolled companies. However, the TPO rejected the Taxpayer’s economic analysis and determined an arm’s length margin of 24.15% on operating cost.

 Provision of administrative and marketing support services
The Taxpayer assisted its AEs in coordination and liaising with the global vendor for the group’s information technology (IT) systems, identification of potential domestic IT support vendors, provision of limited human resource support, provision of inputs on the business opportunities available in the Indian market, etc. The Taxpayer determined this transaction was at arm’s length as the 5% margin on operating costs earned by Taxpayer was more than the 4% margin earned by comparable uncontrolled companies. During the TP audit proceedings, the TPO rejected the Taxpayer’s economic analysis and determined an arm’s length margin of 17.20% on operating costs.

Following the TP adjustments made during audit proceedings, the Taxpayer approached the Dispute Resolution Panel (the Panel). The Panel while largely upholding the TP adjustments gave directions to the Tax Authority on some issues that provided marginal relief with regard to the adjustments. The Taxpayer then filed an appeal before the Tribunal.

Ruling of the Tribunal
Distribution segment
With respect to the AMP expense related adjustment, the Taxpayer argued that since it was earning margins higher than those earned by comparable companies, the AE had supplied goods at lower prices to compensate the Taxpayer for its efforts toward advertising and marketing. Further, as per the company’s TP policy, the compensation model of the Taxpayer is structured in such a manner that the reimbursement of any excess third party expenses (including AMP expenses) is already built in the TP adjustment compensation received by the Taxpayer that allows it to consistently earn an operating margin higher than the comparables. Further, the Taxpayer has consistently maintained that the credit notes or subsidy received should be deducted from the total excess expenditure incurred while calculating the mark-up. The Taxpayer drew reference to one of the factors (the ninth factor) laid down by the SB in the case of LG Electronics (supra) that needed to be considered while determining the value of the international transaction of brand and logo promotion through AMP expenses. According to this factor, “subsidy on purchases” needs to be considered while computing the bright line and should be set off against the excess AMP expenses. Further, another factor (the tenth factor) prescribed that such subsidy should be commensurate with the level of expenditure being incurred by the Taxpayer.

The Tribunal held that higher profitability of the Taxpayer does not form concrete evidence that no excess AMP had been incurred and can be due to several different factors. It is important to establish a connection with specific evidence between the lower prices offered by the foreign parent for goods to the AMP expenses incurred, either directly or indirectly. The Tribunal, in line with the SB, further stated that each transaction has to be benchmarked separately unless two transactions are so closely linked they cannot be separately benchmarked.

It is pertinent to note the Taxpayer drew a comparison with another case i.e., BMW India Private Limited (supra), which was decided by the Delhi Tribunal after the decision of the SB. BMW India acted as a distributor of motor vehicles and parts. During the year, the operating margin of BMW India was higher than those of the comparables. Accordingly, the Tribunal held as follows:

- The case is distinguishable from LG Electronics as BMW India was a sole distributor whereas LG Electronics functioned as a licensed manufacturer.
- BMW India as distributor performed higher functions and undertook to establish distributorship network, advertise, promote and market the brand. Remuneration, compensation, and rewards of distributorship were also guaranteed.
The Tribunal held that unlike *BMW India*, who was only engaged in the business of distribution, the Taxpayer also undertook provision of software development services and administrative and marketing support services. Further, in the case of *BMW India* the Tribunal observed that the Taxpayer has performed the functions of sales promotion and advertisement in order to make a dent in the market and undertook higher functions. Thus, the Tribunal primarily proceeded on the premise that in the remuneration model, the compensation for AMP expenses was duly embedded in the price of the goods imported. The Tribunal held that in case of the Taxpayer, this phenomenon needs to be expressly demonstrated by the Taxpayer with reference to the global transfer pricing policy. In order to connect the subsidy received to the AMP spend, an appropriate agreement between the Taxpayer and the AE laying out the functions and responsibilities of the Indian entity would help. In the case of *BMW India*, one such agreement existed. Further, the Taxpayer had not previously disclosed this reimbursement transaction and thus, it was not even treated as an international transaction to begin with.

Accordingly, the Tribunal held that all such credit notes, documentary evidences relating to the same and samples should be submitted by the Taxpayer to be reconsidered by the TPO and decide on the issue. The Tribunal also directed the TPO to compute bright line percentage by considering expenses that can be categorized as AMP expenses.

**Software Development and Marketing/ Administrative support services segment**
The main issue before the Tribunal was on the appropriateness of certain qualitative and quantitative criteria used by the Taxpayer and TPO for selection of comparable data. A summary of the selection criteria discussed by the Tribunal and the ruling of the Tribunal are summarized below.

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<th>Criteria for selection of comparable companies</th>
<th>Ruling of the Tribunal</th>
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<td>Rejection of potentially comparable companies with significant related party transactions (RPT)</td>
<td>The TPO had applied quantitative criteria of rejecting companies that had more than 25% of operating revenues from RPT. The Tribunal acknowledged in principle the need to apply the criteria to eliminate companies whose margins may be significantly influenced by controlled transactions. The Tribunal ruled that if by applying a lower threshold of 15% for RPT, adequate comparables are available, there is no reason to further extend the threshold to 25%.</td>
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<td>Rejection of potentially comparable companies that have diminishing revenue or persistent losses</td>
<td>The TPO had applied qualitative criteria of rejecting companies that exhibited diminishing revenue or persistent losses. The Tribunal upheld the use of the criteria. Accordingly to the Tribunal, having regard to the analysis of and trends in the information technology industry in India diminishing revenue or persistent losses in a company is an indication of existence of “abnormal circumstances” because of which revenues or profits of that company are not in line with industry trends. Hence, such comparables can be taken into consideration only if reasonably accurate adjustments can be made to eliminate such material differences of these abnormal circumstances.</td>
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<td>Rejection of potentially comparable companies whose employee cost to operating revenues was less than 25% of the revenue</td>
<td>The TPO had applied quantitative criteria based on employee cost for rejecting companies based on the rationale that the criteria would eliminate companies not engaged in provision of software services. While the Tribunal in principle upheld the use of the criteria, it held that the employee cost filter needs to be applied based on the employee cost incurred by the Taxpayer. Accordingly, it held that the filter has to be applied by applying the range of employee cost to sales of 50% to 80% as the Taxpayer had employee cost to sales at 64%.</td>
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<td>Rejection of potentially comparable companies that incur expenses on research and development (R&amp;D) of more than 3% of revenues</td>
<td>The Taxpayer applied quantitative criteria based on R&amp;D expense to eliminate companies that were engaged in software product development and own intellectual property as a result of R&amp;D activities. Considering industry and company analysis, the Tribunal rejected the use of the criteria on grounds that it did not assist in eliminating software product and intellectual property owning companies, even though it acknowledged the need to eliminate such comparables. The Tribunal also observed that software services companies may also incur R&amp;D expenses for improving internal process and methods for service delivery. According to the Tribunal, the criteria did not improve the reliability of the comparability analysis.</td>
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<td>Companies having ratio of advertising, marketing and distribution expenses to sales of less than 3%</td>
<td>This quantitative criterion was applied by the Taxpayer to eliminate companies that may undertake high level of marketing activities. The Tribunal however rejected the appropriateness of the criteria by providing reasons similar to that given for rejecting the criteria based on R&amp;D expense.</td>
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Based on the above guidance for selection or rejection of comparable data, the Tribunal thereafter restored the matter back to the TPO to re-determine the TP adjustment.

The Taxpayer also requested an adjustment to account for risk differences as it was functioning as a limited risk service provider while the comparable companies assumed some degree of risk. The Tribunal directed the TPO to provide a risk adjustment by applying CAPM by availing the services of the technical experts by both the Taxpayer as well as the Tax Authority to compute the risk factor embedded in the profitability of the comparables for software segment. The Tribunal also directed the TPO to provide a working capital adjustment for the administrative support segment.
Implications

TP aspects relating to marketing IP have emerged as a contentious issue in TP audits in India in recent times. A common situation where the issue arises is when an enterprise associated with the legal owner of trademarks performs marketing or sales functions that benefit the legal owner of the trademark, for example through a distribution arrangement. In such cases, it is necessary to determine how the distributor should be compensated for its activities, i.e., whether the distributor should be compensated only for distribution activity or whether the distributor should also be compensated for enhancing the value of marketing IP by virtue of its functions performed. The Tribunal ruling reiterates the principles stated in the case of LG Electronics (supra) need to be considered to determine this issue. The ruling also highlights the importance of a nexus between the AMP activity and expense and the form of compensation to the AE, if the same needs to be considered for evaluating its implications from a TP perspective.

The approach to selection of comparable data has been a challenging issue while dealing with TP aspects of outsourced services. In practice, both quantitative and qualitative criteria may be used to include or reject potential comparables. The choice and application of selection criteria depends on the facts and circumstances of each particular case. The process followed to identify potential comparables is one of the most critical aspects of the comparability analysis. In particular, the choice of selection criteria has a significant influence on the outcome of the analysis and should reflect the most meaningful economic characteristics of the transactions compared. While the Tribunal’s observations on the selection criteria do seem to reflect principle, it also leaves some room for subjective judgments.

The Tribunal’s direction to the Tax Authority on use of independent experts while determining impact of a risk adjustment on the transfer price is welcome. It may be pertinent to note that the Central Board for Direct Taxes, India’s apex tax administration, has issued Instruction No. 5/2011 dated 5 March 2011 directing the Tax Authorities to take the opinion of technical experts in cases involving complex technical issues.

It would be useful for multinational enterprises with Indian affiliates to review the impact of the ruling on their intra-group arrangements involving distribution activities and provision of outsourced services.

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Endnote

1. This Alert discusses only the TP issues that were in appeal before the Tribunal.
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