Marketing intangible issue - How to deal with quandary post SB ruling?

Date : 10 March 2014

Rahul K Mitra, National Transfer Pricing Leader, PWC India

BACKGROUND

1. The country waits with baited breath as the Hon'ble Delhi Court would take up, in the coming weeks, the first round of appeals relating to the issue of marketing intangibles, concerning transfer pricing (TP) adjustments on account of advertisement, marketing & sales promotion (AMP) expenses, emanating from the Special Bench ruling of the Delhi Tribunal in the case of LG Electronics (LG), as also applying to several intervenors, who were parties to the proceedings before the Special Bench.
2. It is understood that neither the main applicant before the Special Bench, i.e. LG, nor any of the intervenors, had filed an appeal before the Hon'ble Delhi High Court *per se* against the ruling of the Special Bench, however, the appeals, which are currently pending adjudication before the Hon'ble Delhi Court, have all being filed against the rulings of the Division Benches of the Tribunal in the cases of the various appellants, most or all of whom were intervenors before the Special Bench, where such Division Benches had merely applied the ratio of the ruling of the Special Bench, being at the detriment of the appellant taxpayers.
3. The issue around marketing intangibles has assumed monstrous proportions in India, particularly post the said ruling of the Special Bench, with several thousands of crore of tax revenue being stuck at various levels of litigation, causing tremendous amount of uncertainty and apprehension in the minds of foreign MNCs investing in India. In short, the Special Bench had ruled that in case a licensee of a brand incurred AMP expenses in excess of comparable companies, which are selected for the purposes of TP analysis, being measured as percentages of turnover, then the licensor of the brand, being the foreign company, would need to reimburse the Indian licensee of the brand for such excess, along with a mark up, for alleged provision of services in developing the brand of the foreign company in India.
4. The Indian Revenue has been taken the above stand, which only got fuelled by the Special Bench ruling, for all types of licensees, namely licensed manufacturers & distributors, irrespective of their casts and creeds, i.e. without considering their characterisations, which are based on functional, asset and risk (FAR) analyses; and approaches & methods adopted for the purposes of TP, being the basic canons or fundamentals of TP. There is no uniform or consistent guidance available with Revenue Authorities & taxpayers as of today, in order to properly understand & apply the concept of marketing intangibles.
5. Thus, the community looks up to the Hon'ble Delhi High Court with great expectations

to set the stage & scene right, with a dictum favouring the subject of TP; and not necessarily either the Revenue or taxpayers. However, it is submitted with great respect that the Hon'ble High Court would perhaps need to address & decide the issue by adopting unconventional methods, as opposed to conventional methods followed in deciding appeals u/s 260-A of the Indian Income Tax Act (Act) with respect to substantial questions of law, since issues relating to TP, particularly a niche & complicated one of the nature of marketing intangibles, have their solutions around appreciation of facts; and applying correct principles, methods & fundamentals of TP; and have nothing to do with the application of legal principles.

6. Therefore, it is submitted with great respect that while dealing with the appeals filed various taxpayers against Division Benches of the Tribunal, which merely applied the principles or ratio of the Special Bench in the case of LG, the Hon'ble High Court would first need to set right all the aspects permeating through the ruling of the Special Bench, notwithstanding or irrespective of the fact that -
    1. the Special Bench ruling is *per se* not pending in appeal before the Hon'ble High Court; and
    2. questions of law framed by the various appellants before the Hon'ble High Court in their respective appeals, might not bring out the inherent defects of the Special Bench ruling in the context of the basic fabric or fundamentals of TP.
7. The task of the Hon'ble High Court might become that much more challenging, since the Hon'ble Institution would be required to do the job, which the Special Bench had failed to do, namely cull out the ruling as per the canons or fundamentals of TP, however, given the graveness of the situation as pending in India; and also the reluctance of the Indian Revenue in issuing circulars or guidelines in line with global best practices in TP, perhaps with a view to shirk responsibility or accountability, which has resulted in a virtual "free for all" situation in the field on a very niche & specialised area of TP, perhaps only the Hon'ble High Court can restore sanity in the relevant area, *albeit at the cost of deviating from conventional methods or approaches in dealing with appeals u/s 260-A of the Act*, dealing with substantial questions of law.
8. Before the author dives deep into the various aspects of the issue around marketing intangibles; and how a balanced view may be taken in this regard, it is important to lay down certain fundamental points, as forming the core of the matter pending before the Hon'ble High Court -

- The relevant issue should not have been taken up for adjudication by the Special Bench in the first instance, since Special Benches are generally constituted for addressing legal issues, which permeate through common set of facts for the main applicant; and also the intervening taxpayers. However, the current issue around marketing intangibles was highly factual, depending upon the functional, asset & risk (FAR) profile of each taxpayer, for which a common dictum could not have been laid down on merits of the issue, applying to taxpayers across the board.

- The proceedings of the hearing suggest that the Special Bench, as per the norms associated with matters to be adjudicated by the Special Bench of a Tribunal, had also expressly mentioned that it would not deal with the facts of any of the interveners. Thus, the merits relating to the facts of any intervener, to the extent different from those of the principal applicant, i.e. LG, could never have been adjudicated with reference to the facts of the principal applicant. Further, the questions framed by the Special Bench were actually fact specific, namely they had regard to the facts and circumstances of the case of the principal applicant; and did not look like addressing any general legal issue.

- The only favourable ruling of the Tribunal in the field of marketing intangibles thus far, has been in the case of BMW India, where the Division Bench of the Delhi Tribunal distinguished the Special Bench ruling on facts, namely that BMW India was predominantly a distributor, as opposed to LG, which was a licensed manufacturer; and thus, the principles of the ruling of the Special Bench would not have applied to the facts of a distributor. The Division Bench of the Tribunal, while deciding the case of BMW India, had also taken cognisance of the affidavit filed by the authorised representative of the appellant, being the author of the present article, to the effect that the Special Bench had categorically or expressly mentioned during the proceedings before it, that the Special Bench would not deal with the facts of any of the interveners; and thus, since the principal applicant before the Special Bench, being LG, was a licensed manufacturer, the case of any distributor, whose facts would have been significantly different to those of a licensed manufacturer, could not have been covered by the principles decided by the Special Bench, again being a statement, which the Special Bench had expressly made in the open court, while permitting BMW India to withdraw its application for intervention in the proceedings before the Special Bench.

- This is quite apart from the fact that the Division Bench of the Tribunal was also satisfied, based upon the arguements made by the taxpayer, that even otherwise, the dictum of the Special Bench had no application to the facts of a distributor of a high-end branded product, like BMW cars. A detailed discussion in this regard has been made later on in the present article.

- The authorised representative of the appellant, while arguing the case of BMW India before the Division Bench of the Tribunal; and also the Division Bench itself, were facing a challenge that the Special Bench ruling in the case of LG could not have been argued or decided as being incorrect, as the same was beyond the province of a Division Bench of the Tribunal, being subordinate to a Special Bench. Thus, instead of going through the ruling of the Special Bench, both the arguements before & the ruling of, the Division Bench, had to go around that of the Special Bench, by distinguishing the ruling of the Special Bench on facts, which incidentally was clearly distinguishable, as discussed in greater lucidity later on in this article.

- In a subsequent ruling in the case of Casio, again concerning the facts of a distributor, another Division Bench of the Delhi Tribunal had held that the principles of the Special Bench ruling in the case of LG applied to both licensed manufacturers & distributors; and further that the earlier Division Bench of the Tribunal was not correct in distinguishing the Special Bench ruling, while favourably deciding the matter in the case of BMW India.

- Now, while deciding the appeals even for distributors, the Hon'ble Delhi High Court would not find itself impeded by the Special Bench ruling in the case of LG, being at a much higher pedestal as compared to any Bench of the Tribunal; and thus the Hon'ble High Court might need to judge on the correctness of the Special Bench ruling on a stand-alone basis, even at the cost of deviating from the conventional approach of deciding appeals u/s 260-A of the Act, in dealing with substantial questions of law, given the virtual state of flux, that is prevalent today.

- The entire industrial fraternity is today looking up to the Hon'ble High Court with great expectations to propound the correct principles of TP in the relevant matter, which unfortunately the Indian Revenue & the Special Bench of the Tribunal have both failed to do.

BROAD PERSPECTIVES OF THE ISSUE AROUND MARKETING INTANGIBLES

Before dwelling upon the ruling of the Special Bench on merits, let us lay down the broad perspectives of the issue around marketing intangibles :

1. Subsidiaries of foreign MNCs, selling products in India under license to use the trademarks or brands of their foreign group companies, being the legal owners of such trademarks or brands, are facing litigation in India, as the Indian Revenue, as a general rule, seeks reimbursement of the alleged excess AMP expenses on the premise that such expenses create marketing intangibles, which benefit the legal owners of the brand and not the local Indian entities.
2. Such excess is determined with reference to the AMP spend, as a percentage of turnover, of the taxpayer, as compared to comparable companies, selected to benchmark the results of the Indian taxpayer in its dealings with its foreign group entities. The level of AMP expenses incurred by such comparable companies is termed as the “bright line”; and anything in excess is termed as non-routine expenses, which the Indian Revenue asserts that the same needs to be recovered from the legal owner of the brand with a mark-up.
3. The sole question that needs to be raised & answered in the context of marketing intangibles, is whether the licensee of the brand had incurred the AMP expenses in the

capacity of a service provider of the legal owner of the brand or in its own account as an entrepreneur ? If the answer to the question is the former, then the next question that would arise, is whether such service provider has been suitably remunerated, in whichever form, for the services incurred on account of promoting the brand of the legal owner ? While, on the other hand, if the answer to the question is the latter, then the whole issue around marketing intangibles becomes a misnomer, since in the real world, an entrepreneur would never seek reimbursement of expenses from another entity, since the entrepreneur would have incurred the expenses on its own account, namely to augment its own business interests, as opposed to the business interests of any other entity.

4. The issue of marketing intangibles becomes important in the context of a distributor, who buys products from the principal manufacturer & sells the same in its jurisdiction under a license to exploit the trademark or brand belonging to the legal owner thereof, since a pertinent question arises, namely has the distributor received adequate or commensurate remuneration for the distribution functions it carries out, including advertising & marketing the product or brand, since the function of distribution, notwithstanding the form of buy-sell under principal to principal basis, is predominantly that of provision of a service; and that the principal manufacturer has the opportunity to limit the rewards of the distributor through the pricing of products.
5. How would the issue of marketing intangibles be addressed in the hands of a distributor ? There is substantial guidance available in this regard in the rulings issued by the Australian Tax Office (ATO) and also the draft OECD guidelines on intangibles. The answer lies in the characterisation of the distributor.
6. In case of a limited risk distributor (LRD), who works with limited FAR profile, the principal manufacturer would typically give a low, but steady remuneration in the form of a guaranteed return on sales (ROS) to the distributor, which can be achieved either through adjustment of pricing of products or reimbursement of expenses. In such a case, the economic ownership of the marketing intangibles created through the AMP spend carried out by the LRD, but at the behest & also based upon the strategies of the foreign principal manufacturer; and also the rewards associated with the same, would vest with the principal manufacturer, with the result that the LRD need not be reimbursed further for any AMP expenses.
7. The only critical point in the LRD structure is for the taxpayer being able to demonstrate the limited FAR profile, namely that all the significant people functions with respect to advertising, marketing & distribution are actually carried out by the foreign principal; and that the LRD merely executes the said strategies. If one is able to demonstrate such profile of an LRD, then the remuneration model of a low, steady and guaranteed ROS, automatically mitigates any further issue on account of marketing intangibles or “bright line”.
8. Next, one may consider the case of a normal risk taking marketing distributor, who would take necessary decisions & also perform functions with respect to AMP & other

distribution strategies. Such normal risk taking marketing distributor would bear reasonable entrepreneurial risks & thus could suffer start up or penetration stage losses as well; and would ideally be remunerated with reference to gross margin, commensurate to what comparable distributors would earn.

9. The ratio of selling and general administrative (SG&A) expenses/ turnover, representing the "intensity of functions", should be considered as a proper filter for selecting comparables under the resale price method for arriving at the gross margin. It has been observed from empirical evidence that comparables chosen with similar intensity of functions as that of the tested party, would generally have more or less similar level of AMP spend as a percentage of turnover, thus mitigating any issue around marketing intangibles.
10. One can conceive of an interesting situation, where, in spite of the best efforts of choosing comparable distributors with similar intensity of functions as that of the tested party, there is a difference in the level of AMP spend between the tested party & the comparable distributors, namely as follows :
    1. Taxpayer's gross margin [GP/ Turnover] is 32%; and AMP/ Turnover is 10%; and
    2. Comparables' average GP/ Turnover is 25%; and average AMP/ Turnover is 5%.
11. The Indian Revenue contends that the taxpayer distributor should receive a reimbursement for the excess 5% spent on account of AMP spend from the legal owner of the brand. Now, guidelines issued by the ATO and the OECD suggest; and rightly so, that in case the distributor carries out extra functions relating to AMP, other strategies around distribution, etc, as compared to comparable distributors, which is reflected through a measure of "intensity of functions", then the tested party distributor should ideally need higher remuneration for carrying out such extra functions, however, such extra remuneration can be rewarded in any of the following manners or forms, namely :
    1. through purchase price of products, i.e. by awarding a higher gross margin to the distributor;
    2. reimbursement for the excess AMP or SG&A expenses of the distributor by the foreign principal manufacturer; or
    3. application of profit split mechanism, if the conclusion drawn is that both the manufacturer & distributor contributes to unique & non-routine intangibles, so as to go out of the realm of one-sided comparability analysis.
12. In the aforesaid example, the additional intensity of functions on account of AMP on the part of the taxpayer distributor, as compared to the comparable companies, being 5% of the turnover, is more than adequately covered or remunerated through a much higher gross margin earned by the taxpayer distributor, as compared to the comparable companies, being 7%.
13. Thus, in such case, it would be a folly to require the taxpayer distributor to receive a separate reimbursement for the extra 5% spend on account of AMP. One needs to

appreciate that reimbursement of the extra AMP spend is not the only way through which a distributor can be compensated for performing extra functions on account of AMP. The said extra remuneration could well be received through the pricing of products, namely through a commensurate higher gross margin. This proposition appears most obvious; and also has the blessings of the OECD & the ATO.

14. There would be the third category of taxpayers, who are entrepreneurs. Such entrepreneurs could be licensed manufacturers, who actually manufacture & sell products in their respective countries under license of intellectual property (IP) in the form of technology & brand of other companies of the group; or they could also be buy-sell entities with a high functional & risk profile.
15. Let us take the case of a licensed manufacturer. It would ideally import some raw materials & spare parts from foreign group companies; and also pay royalty to the legal owner of IP for the exploitation of technology & brand. The raw materials & spare parts are generally supplied by such group companies under a cost plus policy. The rate of royalty for legal ownership of the brand, is also set using the comparable uncontrolled price (CUP) method, with reference to third party license agreements available from global databases; and also possibly corroborated through a profit split method, in order to ensure that the Indian licensee retains a fair share of the entrepreneurial profits, commensurate with the contributions made towards developing of the non-routine marketing intangibles in India for itself.
16. Since the taxpayer would be an entrepreneur and accordingly a complex entity, one would not test or benchmark its results with similar comparable entrepreneurs of its country or region. The international transactions entered into by such licensed manufacturer with its foreign group entities would have been adequately tested and benchmarked under the transaction by transaction approach, as above.
17. However, in several cases, Indian taxpayers, who are even entrepreneurial licensed manufacturers, have ended up testing or benchmarking their results with similar entrepreneurial comparables, under an overall transactional net margin method (TNMM). This opens up complexities in TP, where the Revenue Officer tries to compare the level of AMP spend of the taxpayer, as a percentage of its turnover, against the same of comparable companies, followed by the resultant conclusion that any excess AMP spend by the taxpayer would need to be reimbursed by the legal owner of the brand, since the taxpayer has allegedly created marketing intangibles on behalf of the legal owner of the brand.
18. The genesis of the entire dispute around marketing intangibles in the case of entrepreneurial license manufacturers, lies in the incorrect approach of TP through selection of the wrong “tested party” for the purposes of benchmarking analysis.
19. Since the Indian entrepreneurial taxpayer could not have been tested under the fundamentals of TP, there was no question of comparing the AMP spend of the taxpayer with other comparable companies, who are also entrepreneurs, since the said companies are actually not comparables so far as the taxpayer is concerned. The entire

gamut of marketing intangibles in such cases is in reality a “non issue” or a misnomer, which has unfortunately assumed monstrous proportions, with the various constituents being unable to appreciate the actual cause of the dispute.

20. The same principle would also apply to entrepreneurial buy-sell companies, who purchase finished products from foreign group companies under a cost plus model; and then sell the products in their own countries, by assuming the significant entrepreneurial risks of the market. This applies typically for products, which are low on technology; and the success of which primarily depends upon the local marketing & distribution strategies of the selling entities. To a common man, the selling entity might appear to be a distributor at first blush, however, a proper FAR analysis of the selling entity would reveal its characteristics of an entrepreneur, whose results should again not be tested against comparable companies, with the resultant corollary that the marketing intangible issue should not apply to such cases as well.
21. The pivotal point involved in the cases of such entrepreneurial licensed manufacturers or buy-sell companies, is that having purchased raw materials or finished products from foreign group companies under a cost plus model; and also having paid royalties for the legal ownership of the brand at market driven rates, the residual or entrepreneurial profits, *interalia* relating to economic ownership/ exploitation of the IP, are actually enjoyed by such entrepreneurial licensed manufacturers or buy-sell companies; and accordingly and as a corollary, all expenses around AMP incurred for the enjoyment of such entrepreneurial profits would necessarily need to be borne by such companies. The legal owner of the brand would never pick up any portion of the AMP expenses of the licensee, since such legal owner of the brand would not enjoy the fruits of the same.
22. As mentioned earlier, corroboration of the CUP study for royalty, by applying the profit split method, would ensure that the Indian licensed manufacturer has retained its fair share of entrepreneurial profits, commensurate with the contributions made towards developing of the non-routine marketing intangibles in India for itself.
23. One of the contentions of the Indian Revenue has been that the Indian licensee should always receive reimbursement from the foreign licensor of the brand for the said alleged excess spend on account of AMP, for assisting the latter to build up the brand for possible future direct exploitation of the same, in isolation of the Indian licensee. The arguments may be validly countered as follows :
    1. The above attempt would be akin to putting an honest businessman behind bars on the ground that he is capable of committing a crime in future.
    2. In case he commits a crime in future, then, at such future stage, the State might impute him with whatever legal measures, as would be available.
    3. However, until he commits a crime, he cannot be penalised for a crime, which he has not even committed; and may not also actually commit in future.
    4. In case the State still wants to put the businessman behind the bars now, in that case, he would also be prevented from earning profits in the present; and

accordingly, the State would also lose its share of taxes on the profits, which the businessman could have otherwise earned.

5. Juxtaposing the above arguements in the case of Indian licensee would mean that in case the foreign licensor of the brand would have exploited the brand in future in India, by depriving the Indian licensee, then at that stage, one could consider to evaluate whether the Indian licensee would have deserved any compensation for impairment of its rights under the license agreement.
6. However, by requiring the Indian licensee to receive reimbursement of the extra AMP expenses in the present day, the said Indian licensee would be reduced to a service provider of the foreign licensor; or its profile would be downgraded to that of a limited risk manufacturer, with the result that the residual or entrepreneurial profits relating to the commercial exploitation of the marketing intangibles, should actually be repatriated in favour of the foreign licensor as higher royalties or through reduction in import price of goods.

24. Taxpayers have tried to defend themselves through several lines of legal arguements, including that the whole concept of marketing intangibles does not constitute any “international transaction”, which the Special Bench had dismissed. It is submitted that the issue around marketing intangibles cannot be addressed by taking recourse to such legal arguments, since the issue is one concerning the fundamentals of economics & TP; and thus the same deserves to be best addressed with reference to the touchstone or bedrock of the economic theories of TP. Placing reliance on such arguements is like touching the skin, but missing the soul of the subject.
25. It is submitted that "marketing intangible" is an asset, albeit an intangible asset. The OECD has proposed to define the said term as "an intangible used in business operations, that are customer facing". The said term includes brands, trademarks, trade names, customer lists & relationships, proprietary market & customer data, etc, which are used in marketing & selling of products or services to customers.
26. The critical point in TP with respect to marketing intangibles, as discussed above, resolves around the fact, namely which entity within the MNE group economically owns the non-routine marketing intangibles; and whether the said entity has received adequate rewards for the economic ownership thereof. The answer to such question or issue can only be found through a proper FAR analysis & characterisation of the entities; and also selecting proper methodologies & "tested party" from a TP standpoint; and not in searching whether there exists any "international transaction" from bringing the issue within the ambit of TP.

COMMENTS ON VARIOUS OBSERVATIONS OF THE SPECIAL BENCH ON MERITS OF THE CASE

The Special Bench had made several observations & also laid down certain dictums on the merits of the issue around marketing intangibles. The said observations, collectively; and not necessarily in isolation or independently, had shaped the final outcome of the ruling. Some of the major observations of the Special Bench; and the comments with respect to the same, are highlighted as under –

Legal and economic ownership of brand

Special Bench's observations

The Special Bench held that there is no difference between legal & economic ownership of brand, from the perspective of taxation laws, though such difference might exist in commercial parlance.

My comments

1. The blanket dictum of the Special Bench in this regard, cannot be accepted. There are two elements of returns related to brand, which is a constituent of marketing intangibles, namely one for legal ownership; and the other for economic ownership.
2. The Special Bench has held that in case the legal owner of the brand sells the same to a third party, then the distributors, wholesalers retailers, etc, might not be entitled to any share of the sale proceeds thereof. The matter cannot be addressed so simply. The value of a brand arises primarily from its usage, though the legal ownership of an otherwise globally reputed brand also has significant value.
3. Now, the distributor, wholesaler & retailer, would not each have license to exploit the brand. It is the distributor, who is ideally the licensee, having rights to exploit the brand. The wholesaler & retailer are ideally distribution channels or network, which the distributor creates, as part of its distribution functions, which actually constitute a part of the marketing intangibles.
4. To the extent the significant people functions with respect to creation of such distribution channels & also framing strategies around AMP, are carried out by the distributor in the capacity of licensee of the brand, the distributor becomes the economic owner of such marketing intangibles.
5. If during the course of transfer of the legal rights in the brand, the license enjoyed by the distributor is not terminated or impaired in any way, by the new legal owner of the brand, then the distributor should not ideally be entitled to a compensation for such transfer. Also, in such circumstances, the price payable by the buyer of the brand to the seller might be on the lower side, in case a significant value stands associated with the economic ownership thereof in the hands of the licensee distributor.
6. On the other hand, if during the course of transfer of the legal rights in the brand, the license enjoyed by the distributor is terminated or impaired in any way, then the distributor might seek compensation from the legal owner of the brand, depending upon the terms of the contract, level of investment put in by the distributor under the

assumption of long-term rights in the license, practice/ custom followed in the relevant country, etc. Incidentally, this is the key aspect of “exit charge”, which Revenues across the world vie for in the context of business restructuring transactions, on which the OECD and ATO have brought out detailed guidelines. Thus, the blanket statement of the Special Bench in this regard, is not correct.

7. The Indian tax laws can only comment upon how a compensation received upon impairment of a license agreement can be taxed; and not whether a licensee can at all receive any compensation upon impairment of the license agreement, which is otherwise governed by the commercial laws of India.
8. Incidentally, even section 28(ii) of the Act conceives of situations where compensation are received for termination of agency agreements, namely that the same would be taxed as business incomes. Thus, whenever valuable rights under any agreement, e.g. agency, distribution, etc, are impaired, there could be a need to compensate the affected party; and the Indian tax laws duly recognise the same for laying down a mechanism for taxing the same.

Promotion for product & promotion for brand

Special Bench's observations

The Special Bench made a distinction between the concept of AMP for the product, which it associated with the licensed manufacturer; and AMP for the brand, which it associated with the legal owner of the brand. The Tribunal mentioned that if the licensed manufacturer incurred AMP expenses to promote the value of the brand, as opposed to promoting the product, which it was selling, in that case, to the extent such AMP expenses, as a percentage of turnover, would exceed the same of comparable companies, then such licensed manufacturer could be said to be rendering a service to the legal owner of the brand, for which a compensation in the form of reimbursement was required.

My comments

1. It appears that the Special Bench was not properly assisted by the parties to the dispute. There was no need to make such differentiation between AMP for product and AMP for the brand. In fact, one doubts, whether such distinction can at all be made in any objective or subjective manner whatsoever.
2. The crux of the matter, which the taxpayers unfortunately did not raise before the Special Bench; and accordingly, the Special Bench perhaps did not have the occasion to consider, was that if the licensed manufacturer was characterised as an entrepreneur, then it was incapable of being tested, whether for arriving at the arm's length prices of transactions entered into with its related parties in the capacity of such entrepreneur, or for the purposes of comparing its AMP expenses.

3. Just like Tata Steel cannot be compared with Jindal Steel or Essar Steel, as all three are high end entrepreneurs, owning & exploiting valuable IP, similarly, entrepreneurial licensed manufacturers like say Hyundai, cannot be compared with other entrepreneurs, who are either legal owners of brands, e.g. Tata Motors, Mahindra & Mahindra, Ashok Leyland, etc, or licensees of brands, e.g. Fiat, Ford, General Motors, etc, since the strength of two IPs can never be compared.
4. However, as discussed earlier, taxpayers being entrepreneurial licensed manufacturers, have also not helped their causes by testing their profits under an overall TNMM, by selecting similar entrepreneurial companies. The genesis of the problem starts and ends there.

Extra profits under overall TNMM does not insulate taxpayer from bright line adjustment

Special Bench's observations

The Special Bench held that even if under an overall TNMM, the taxpayer's profit level indicator (PLI), say ROS, was higher than the average PLI of the comparables, the taxpayer could still face an adjustment on account of excess AMP spend, in the manner discussed above.

My comments

1. As discussed earlier, the observations must be read in a manner so as to relate to the facts of a licensed manufacturer, as placed before the Special Bench, subject to the underlying & principal caveat that an entrepreneurial licensed manufacturer cannot be tested and accordingly, cannot have any comparables in the first place or instance. Thus, the observations in this regard, for an entrepreneurial licensed manufacturer, becomes a misnomer, if the case is presented based upon the fundamentals of TP, which includes carrying out of a proper characterisation & selection of the correct "tested party".
2. As has been discussed above, the issue of marketing intangibles becomes important in the context of a distributor, who buys products from the principal manufacturer & sells the same in its jurisdictions under a license to exploit the trademark or brand belonging to the legal owner thereof, since a pertinent question arises, namely has the distributor received adequate or commensurate remuneration for the distribution functions it carries out, including advertising and marketing the product or brand since the function of distribution, notwithstanding the form of buy sell under principal to principal basis, is predominantly, a service; and that the principal manufacturer has the opportunity to limit the rewards of the distributor through the pricing of products.
3. As further discussed above, a normal risk taking marketing distributor, who carries out

extra functions on account of AMP & distribution strategies, as compared to other distributors in the market, which is reflected through a measure of "intensity of functions", should ideally need higher remuneration for carrying out such extra functions, however, such extra remuneration can come either in the form of reduction in purchase price of products, namely through awarding a higher gross margin to the distributor, or through a reimbursement for the excess AMP or SG&A expenses of the distributor by the foreign principal manufacturer, or in an extreme case, under a profit split mechanism.

4. One need to appreciate that reimbursement of the extra AMP spend is not the only way through which a distributor can be compensated for performing extra functions on account of AMP. The said extra remuneration could well be received through the pricing of products, namely through a commensurately higher gross margin. This principle has been explained in detail by both the OECD and the ATO in their guidelines; and appears to be the only logical conclusion.
5. As mentioned earlier in the present article, the ruling of the Special Bench, if read properly, would not apply to the facts of a distributor, for the reasons discussed below, quite apart from the fact that the basic premise of the ruling of the Special Bench is itself erroneous, albeit fuelled due to lack of necessary guidance on the part of the litigants :

- While laying down some of the questions/ issues, which the Special Bench thought to be relevant in the context of the subject around the marketing intangibles, the Special Bench did record a question, namely *whether the Indian company was simply a distributor or holding a manufacturing licence from its foreign related party ?*

- One needs to keep in mind that the Special Bench was deciding the issue in the context of, or with reference to, the facts of a licensed manufacturer; and not those of a distributor. After having posed the said question, the Special Bench had never proceeded to hold in clear & certain terms as to what principles would apply if the case of a taxpayer was that of a distributor.

- Incidentally, the Special Bench had also accepted the fact that there can be *no straitjacket formula* for giving weightage to each of the factors/ questions highlighted in its ruling; and what would be the result of each of such factors/ questions in determining the cost/ value of international transactions, would depend upon the facts of each case.

- At one place of the ruling, the Special Bench had rejected the contention of the assessee that if the overall profit of the Indian entity was more than the comparable cases, then it should be presumed that the foreign enterprise supplied goods at relatively low price to make up for the AMP expenses incurred in India towards brand promotion. The Special Bench went on to hold that in order to take the benefit of such a contention, the assessee was required to directly prove the fact of cheap purchases *de hors* the overall higher net profit rate. The Special Bench held that the stated fact could be established by demonstrating that the foreign related party charged a specially low price from the taxpayer in comparison to that charged for similar goods supplied to other independent entities dealing with it in India or in case there was no other independent entity in India, then the price charged for similar goods from other foreign parties. The Special Bench further held that it could also be proved by showing that goods with identical features were available in the Indian market at a higher price. The Special Bench also held that the fact that the taxpayer had a better net profit rate in comparison with other comparable entities was not decisive in itself of the taxpayer having purchased the goods at a concessional rate from a foreign related party as a compensation for incurring incremental AMP expense towards the promotion of the brand owned by the foreign related party.

- It is submitted that the only logical conclusion, which can emanate from a proper reading of the aforesaid observations of the Special Bench is that the same cannot apply to the facts of a distributor of high-end branded products, like say BMW cars, which are embedded with unique intangibles in the form of high-end technology & brand, *even if the Special Bench had not expressly mentioned the same*, as was appreciated by the Division Bench of the Tribunal, while deciding its case.

- The rationale for the aforesaid submission is that the “tests” conceived of by the Special Bench can never apply to the facts of distributor of uniquely branded products, like say BMW cars. The Special Bench had stated that in order to claim the benefit of the argument of premium profits, the taxpayer has to demonstrate that the foreign related party charges a specially low price from it in comparison with that charged for similar goods supplied to other independent entities dealing with it in India or in case there are no other entity in India then the price charged for similar goods from other foreign parties. It is submitted that the said test cannot even be applied in the case of a high-end branded product, like BMW cars, since BMW Germany would not sell BMW cars to any other independent entity in India; and also to any other independent entity in any foreign jurisdiction. BMW Germany would always sell the products through its subsidiary distributors across the world.

- The Special Bench had conceived of another test namely whether goods with identical features are available in the Indian market at higher prices. It is submitted that for a premium product like BMW cars, which rides on unique intangibles in the form of technology & brand, no comparison for absolute prices can ever exist, since similar products are not sold in the market either in India or any other part of the world.

- Accordingly, the tests conceived by the Special Bench cannot, under any circumstances whatsoever, be said to be applicable to a distributor of a branded product, which is associated with unique intangibles in the form of technology & brand, thus leading to the obvious conclusion that *the dictum of the Special Bench on the issue of premium profits under an overall TNMM not being an automatic insulation from the adjustment around marketing intangibles*, needs to be restricted only in the context of a licensed manufacturer, purchasing raw materials from the foreign related parties to manufacture products in India.

- The above elucidation is again without prejudice to the primary submission that making AMP adjustments in the context of licensed manufacturers, being entrepreneurs, by taking recourse to the umbrella of an overall TNMM, is itself entirely erroneous, for the reasons discussed in detail above.