**AMP adjustment in case of licensed manufacturer with large turnover and a fully operational manufacturing, marketing and distribution system in India struck down**

**May 09, 2016**

**In brief**

The taxpayer was primarily a licensed manufacturer. It had entered into a brand license agreement with its associated enterprises (AE) in lieu of a royalty payment. The Transfer Pricing Officer (TPO) alleged that there was an arrangement between the taxpayer and its AE by virtue of which the taxpayer incurred excessive advertisement, marketing and promotion expenses (AMP), and thereby promoted the brands owned by the AE. The TPO proposed an adjustment on account of such AMP spend. The Tribunal ruled in favour of the taxpayer and held that the AMP incurred did not result in an international transaction.

**In detail**

**Facts**

The taxpayer¹ was primarily a licensed manufacturer engaged in food processing. The taxpayer had entered into a brand license agreement for the use of brands owned by its AE in lieu of a royalty payment. During the transfer pricing audit proceedings, the TPO alleged that there was an arrangement between the taxpayer and its AEs by virtue of which the taxpayer incurred excessive AMP, and thereby promoted the brands owned by the AE.

The TPO proposed an adjustment by:

- Using Profit Split Method (PSM), wherein 35% of the group profit was attributed to the AMP function².
- Alternatively, he applied the Bright Line Test (BLT) to compute the non-routine AMP incurred by the taxpayer, and arrived at the value of adjustment after applying a 10% mark-up on the non-routine AMP.

The Dispute Resolution Panel held that PSM was not an appropriate method. However, it upheld the TPO’s action of applying BLT with a mark-up of 9.8%. Aggrieved, the taxpayer appealed to the Income-tax Appellate Tribunal (the Tribunal).

**Tribunal ruling**

The Tribunal ruled in the taxpayer’s favour and held that AMP incurred did not result in an international transaction, and that the TPO had wrongly invoked the provisions of Chapter X of the Income Tax Act, 1961. In holding so, the rationale followed by the Tribunal was as follows:

- Since there was no agreement between the taxpayer and the AE whereby the taxpayer was obliged to incur AMP of a certain level for the AE for the purpose of promoting

¹ TS-194-ITAT-2016(Mumbai-TP)
² Relying on a precedent Delhi Tribunal decision [ITA No. 1496 to 1501/Del/2007].
the AE’s brand, no international transaction could be presumed. Reliance in this regard was placed on the principles laid down by the Delhi High Court in a recent decision (Delhi High Court verdict)³.

- The taxpayer paid royalty to the AEs, based on the license agreement entered into between the taxpayer and the AEs on a principal-to-principal basis. Royalty payment was one of the criteria to hold that the taxpayer was an independent unit.

- The TPO had not brought on record any evidence to prove that the taxpayer had rendered any AMP related services to its AE. On the contrary, payments on account of AMP were made to unrelated domestic third parties.

- The taxpayer had a fully operational manufacturing, marketing and distribution system in India. The taxpayer’s manufacturing unit had a huge turnover, which proved that the taxpayer had done reasonably good business. Accordingly, AMP was incurred by the taxpayer to promote its own business interests, and it could not be said that the AMP incurred by the taxpayer was aimed to benefit the AE and that it should be compensated for it. The TPO had also failed to prove that the intent of the taxpayer was to promote the AE’s brands and not its own business.

- The resultant profit was offered for taxation in India. Therefore, transferring of profit from India, the basic ingredient to invoke TP provisions, remained unproved.

### The takeaways

In the instant case, the Tribunal has echoed the Delhi High Court’s verdict, and has gone a step further in clarifying and clearly articulating some more positions around the AMP issue.

**An important observation made by the Tribunal is that a royalty agreement entered on a principal-to-principal basis, demonstrates the taxpayer’s independence (an Indian licensed manufacturer in the instant case).** Notably, this observation has been made by the Tribunal in the context that AMP incurred by the taxpayer is to promote its own business interests (since it is an independent business unit) and not the brands owned by the AE. This is an important observation, as revenue authorities have often used payment of royalty by an Indian licensed manufacturer as a pretext to argue either that there is no need for AMP spend or that there is a need for compensating the AMP spend.

Another noteworthy position laid down by the Tribunal in the instant case is that a mere allegation of enhancement of AE’s brand value through AMP incurred by the taxpayer is not sufficient. The TPO ought to have demonstrated such enhancement before making an adjustment.

Furthermore, the Tribunal has acknowledged that AMP is incurred to promote the taxpayer’s own business interests, and the fact that the profits earned by the taxpayer are subject to taxation in India implies that there is no base erosion. This is an important overriding principle which has been often ignored when dealing with the AMP issue.

These positions, as enunciated by the Tribunal, support many contentions often put forth by taxpayers who have been faced with TP adjustments on account of AMP. This verdict is, therefore, undoubtedly a positive and welcome precedent.

### Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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³ Please refer to our news alert on this decision (ITA 110/2014 and ITA 710/2015)