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No separate compensation necessary for excessive AMP when sufficient profits received by distributor as part of pricing; SB ruling in LG Electronics case distinguished

In brief

- In a recent decision in the case of an Indian subsidiary of a globally renowned premium automobile group ('the taxpayer'), the Delhi Bench of the Income-tax Appellate Tribunal ('the Tribunal') has distinguished the Special Bench Ruling in case of LG Electronics[1] ('SB Ruling') with regard to issue of marketing intangibles in the context of a distributor. The Tribunal adjudged that **if the distributor was sufficiently compensated by the foreign principal through the pricing of products, i.e. through higher gross margins, the same would have catered to extra AMP expenses, if any, spent by the distributor as compared to the comparables.** ***Accordingly, no separate compensation in the form of reimbursement of excess AMP expenses was required from the principal*** when the taxpayer was already earning premium profits as compared to comparables with similar intensity of functions.

- The Tribunal acknowledged that in absence of a specific provision in Income - tax Act, the Revenue could not insist that the mode of compensation for AMP expenses by foreign principal to Indian taxpayer (who is a distributor) necessarily be direct reimbursement and not pricing adjustment. The said remuneration for extra AMP could well be received through the pricing of imported products, namely through a commensurately higher gross margin.

[1] LG Electronics India Private Limited *v.* ACIT (2013) 29 taxmann.com.300

Facts

- The taxpayer was primarily engaged in the import and sale of premium segment cars imported as completely built units ('CBU') in India. In addition to such distribution function, it also carried out assembly of completely knocked down ('CKD') kits for particular segments of cars, which tantamounted to value-added distribution function.

- As per an inter-company agreement, the taxpayer was appointed as an importer and distributor of CBUs, CKDs and original automobile parts accessories in India against payment of appropriate consideration. The agreement also stipulated that the taxpayer had to advertise, promote sales, establish and supervise an efficient distribution network in India.

- The taxpayer had applied Resale Price Method (RPM) as the primary method for establishing the arm's length pricing of its imports from its foreign parent. During the transfer pricing (TP) audit proceedings, the Transfer Pricing Officer ('TPO') alleged that the taxpayer had incurred excessive AMP expenses as a percentage to sales as compared to its comparables, which led to brand promotion activities and resulted in creating marketing intangibles for its foreign parent. The TPO was of the view that the taxpayer ought to have received reimbursement for the excessive AMP incurred by it along with a mark-up from its foreign parent.

- The taxpayer, in its response, submitted an analysis of comparables with similar functional intensity. Based on the analysis, the taxpayer contended that it was earning higher margins both at gross margin and operating margin levels as compared to comparable companies. Thus, it was adequately remunerated by the foreign parent for its increased functional intensity and no further remuneration was required for its incremental AMP expenses.

- The taxpayer also referred to relevant international guidance[2] to corroborate that no separate remuneration was required for the AMP expenditure incurred by it when the same was embedded in the pricing of imported goods resulting in higher gross margins.

Revenue's contentions

The Revenue primarily relied on the orders of TPO and DRP and SB Ruling in case of LG Electronics[1] while presenting the arguments in favour of adjustment on account of excessive AMP spend of the taxpayer along with a mark-up.

- The Revenue contended that the taxpayer had incurred AMP expenses far beyond the requirements of a normal distributor and this had resulted in the brand promotion of the foreign principal, who was the legal owner of the brand; and that consequently the brand had gained value. Accordingly, it should have been compensated for the services rendered by the taxpayer by a mark-up on the AMP costs over and above the 'bright line' limit.

- The Revenue also contended that the taxpayer's distribution rights were quite tenuous and could be terminated at short notice and thus, it would not be compensated for such consequential loss of business as well as for excessive AMP expenses. Accordingly, the taxpayer should be compensated for excessive AMP along with a mark-up.

- The Revenue also stated that high margins earned by the taxpayer when compared to its comparables were not relevant as higher margins could be attributed to many factors like economies of scale, low overheads and other factors like low-end assembly, etc. and may not have any nexus with the pricing of imported goods.

- The Revenue also argued that the reliance placed by the taxpayer on OECD

[2] International guidance on marketing intangibles refers to OECD Transfer Pricing Guidelines ,OECD's Discussion Draft on Intangibles (Chapter VI of the OECD Guidelines), and Australian Tax Office's Guidelines related to Marketing Intangibles

Guidelines was misplaced as the issue had to be decided on the basis of Indian laws and judgements and India was not a signatory as far as the OECD Guidelines were concerned, as the concerns and the interests of a developing country like India were very different from the concerns of developed countries.

- The Revenue contended that the SB Ruling had laid down the law on the various aspects of transfer pricing on the nature of AMP spend, holding it to be an international transaction and upholding the 'bright line' concept as a tool for calculating the arm's length price and such legal aspects of the SB Ruling applied equally to a licensed manufacturer and to distributors.

Taxpayer's contentions

The taxpayer contested the Revenue view's by presenting the following arguments:

- The taxpayer strongly contended that the taxpayer's facts are distinguishable from the facts in the LG Electronics[1] case since the taxpayer was predominantly a distributor of automobiles with value-added assembly functions, while LG Electronics operated as a licensed manufacturer. It was vehemently stated that the principles laid down by the SB Ruling on AMP do not address the facts of a distributor and thus, the taxpayer is not prohibited from bringing out the distinction between the Functional Assets Risks (FAR) analysis of a licensed manufacturer and that of a distributor.

- The taxpayer explained that the act of distribution was akin to a service performed by the distributor in favour of the manufacturer of products. A Distributor's only function was to provide a supply chain service to the manufacturer; and in the process, perform necessary marketing and selling functions. The entire gamut of marketing and selling functions was an integral and non-detachable part of the distributor's functions; and the profits from the respective sub-functions were subsumed in its overall rewards in terms of net margin or gross margin.

- The taxpayer contended that it operated as normal distributor and was remunerated through an adequate gross margin on sales commensurate with its increased functional intensity. Accordingly, the reimbursement for the AMP expenses had already been factored in the pricing which ensured that adequate profits were retained in India by the taxpayer (after meeting its costs), which are much more than those of a routine distributor; and no further remuneration was necessary. The taxpayer had empirically demonstrated that additional remuneration had already been recovered by the taxpayer through premium profits at both, the gross margin level as well as the net margin level.

- The taxpayer contended that the assumption of the Revenue that distribution rights of the taxpayer could be terminated at any time by its foreign principal, and that the taxpayer would be deprived of the fruits of its efforts towards the foreign parent's brand building, was presumptive. Accordingly, an adjustment in anticipation of a future contingency was not sustainable in fact or in law.

- In the light of international guidance on the subject of marketing intangibles[2], the taxpayer submitted that a distributor could be remunerated for the services/functions performed either by adjusting the pricing or by compensating the entity directly for excess marketing and advertisement expenditure or by applying residual profit split method. The Revenue could not compel payment of such remuneration only by way of direct reimbursement of the excess expenses along with a mark-up, since flexibility in the manner of conducting business was the taxpayer's prerogative and not the Revenue's, as explained by the OECD and the ATO guidelines.

Tribunal Ruling

After considering the rival contentions, the Tribunal's key conclusions were as follows:

- In view of the binding precedents from the SB Ruling as far as the legal transfer pricing aspects of AMP transactions were concerned, the Tribunal upheld the fact that AMP was an international transaction and 'bright line' was an accepted tool for calculating the arm's length price.

- The Tribunal observed that the taxpayer had performed the function of sales promotion and advertisement in order to make a dent in the market. It also held that the taxpayer was performing functions of greater intensity and consequently, it upheld the contention that AMP expenditure over and above those of comparables was non-routine and had assisted in promoting the brand of the foreign parent.

- In view of the premium profits of the taxpayer at both, the gross and the net level, the Tribunal was convinced that compensation for non-routine brand building services by the taxpayer was embedded in the pricing of imported goods only, and therefore no separate compensation was required from the foreign principal.

- The Tribunal further directed exclusion of account items like after-sales support, dealers' and salesmen's bonus, etc. in calculation of AMP expenditure of the taxpayer.

- The Tribunal also upheld the contention that in the absence of any guidelines or any stipulations in the Indian Tax laws that run contrary to international guidance, there was, and can be, no bar to refer to OECD TP Guidelines and International Tax Practices Jurisprudence.

PwC Observations

After a spate of negative rulings on the issue of marketing intangibles following the SB Ruling in the case of LG Electronics[1], this is the first favourable ruling on marketing intangibles at the Tribunal level. In terms of key takeaways, the following points which have been acknowledged by the Tribunal in the instant ruling are worth a mention:

- In the first ruling of its kind, the Tribunal has upheld the contention that no separate compensation is needed for excessive AMP expenditure, when the distributor receives sufficient profits/ rewards as part of the pricing of goods imported from its foreign principal.

- The Tribunal has upheld the contention that a judgement or a decision considered as a binding precedent necessarily has to be read as a whole. To decide the applicability of any section, rule or principle underlying the decision or judgement which would be binding as a precedent in a case, an appraisal of the facts of the case in which the decision was rendered is necessary. The scope and authority of a precedent should not be expanded unnecessarily beyond the needs of a given situation.

- The Tribunal acknowledged that transfer pricing litigation and adjudication is a fact-intensive exercise which necessarily requires due consideration of the taxpayer's business model, contractual terms entered into with the AEs and a detailed FAR analysis, so as to appropriately characterize the transactions and the business model. The Tribunal has also supported the fact that there can be no straitjacket to decide a transfer pricing matter.

- The Tribunal has dwelt on this aspect and categorically acknowledged existence of a fine line of distinction between the FAR profiles of a manufacturer vis-à-vis that of a distributor. Consequently, the remuneration model and the transfer pricing analysis for one could vary from the other.

- The principle of judicial discipline was reiterated by the Tribunal in the instant ruling.

- The Tribunal also affirmed that in the absence of suitable aids or guidelines in the Indian tax laws or jurisprudence, there is no bar/ prohibition to refer to international jurisprudence/ guidelines.

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