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Special Bench ruling on LG Electronics is applicable to all classes of assesseees, whether they are licensed manufacturers or distributors, irrespective of their risk profile

In brief

A Delhi bench of the Income-tax Appellate Tribunal (the Tribunal) pronounced a judgement on the marketing intangibles issue in the case of Casio India Co. (P) Ltd.¹ (Casio India) for assessment years (AYs) 2007-08 and 2008-09. The Tribunal held that:

- Incurring Advertisement, Marketing and Promotion (AMP) expenses towards promotion of brands legally owned by foreign Associated Enterprises (AEs) constitutes a transaction and needs to be separately benchmarked in all cases

¹ I.T.A. No. 6135/Del/2012 & I.T.A. No. -5166/Del/2012

- Special Bench ruling (SB ruling)² is applicable with full force on all classes of assesseees, whether they are licensed manufacturers or distributors, irrespective of their risk profile
- The 14 parameters listed in the SB ruling to be examined in each case for arriving at a conclusion

Facts

- Casio India is a wholly owned subsidiary of Casio Computer Company Ltd, Japan (Casio Japan);

² I.T.A. No. 5140/Del/2011

- It was engaged in distribution of watches, consumer information products and other related products supplied by Casio Japan;
- It had adopted transactional net margin method to justify the arm's length nature of its international transactions;
- The transfer pricing officer (TPO) did not challenge the profitability of Casio India but questioned the AMP expenses incurred by Casio India;
- The TPO held that Casio India had incurred excessive AMP expenses and the same should be recovered from Casio Japan along with an arm's length mark-up;
- Casio India appealed before the Commissioner of Income-tax (Appeals) (CIT(A)) for both AYs 2007-08 and 2008-09. For AY 2007-08, the CIT(A), while deleting the adjustment made by the TPO, held that Casio India was an exclusive full-fledged distributor of Casio products in India and AMP expenses were linked to distribution activity. Per the CIT(A), the benefit of AMP expenses was primarily to Casio India and any benefit to Casio Japan was incidental. For AY 2008-09, the CIT(A) confirmed the addition made by the TPO.
- The Revenue and Casio India filed appeals before the Tribunal against the orders of the CIT(A) for the AYs 2007-08 and 2008-09 respectively.

Taxpayer's contentions

- Casio India contended that Casio India was a sole distributor of Casio products in India. Such products were imported from Casio Japan and were sold without any value addition; hence, the AMP expenses being incurred were incurred as a part of the Casio India's distribution function and the benefit accruing to the AE was only an incidental benefit
- The taxpayer was the sole beneficiary of the AMP expenditure incurred by it, and its conduct in incurring and bearing the cost of such expenditure was consistent with the arm's length price

- Casio India relied on a ruling pronounced by the Delhi bench in the case of BMW India Pvt. Ltd.³ ('BMW India') and stated that no adjustment on account of AMP expenses was required to be made in case of a full fledged distributor.

Revenue's contentions

- Upon a reference made by the Assessing Officer (AO), the TPO noticed that Casio India incurred certain sum on AMP expenses, out of which a sum of Rs. 26,350,982/- was held to be towards developing marketing intangibles for the AE and only a sum of Rs. 10,212,645/- was reimbursed by the AE
- Consequently, the TPO proposed an adjustment by adding a mark-up of 14.93% on the differential amount
- Since Casio India was a full-fledged distributor, the CIT(A) held that there was no justification in calculating some benefit of AMP expenses going to the AE and no further mark-up was warranted.

Tribunal's ruling

- The Tribunal largely relied on the order passed by the SB in case of LG Electronics and seconded the examination of 14 parameters for a taxpayer to correctly determine the ALP of AMP expenses
- The Tribunal discussed the first two parameters laid down by the SB and concluded that the SB ruling was applicable with full force on all classes of assesseees, whether they were licensed manufacturers or distributors, irrespective of their risk profile
- The Tribunal opined against Casio India's reliance on BMW India ruling and considered the SB order in LG Electronics to have more force and binding effect over the Divisional Bench order on the same issue

³ I.T.A. No. 5354/Del/2012

PwC's observations

- The positive sentiment created by the BMW ruling on the issue of marketing intangibles for distributors has been dampened by the Casio ruling wherein the Tribunal has relied on the SB ruling and decreed against the taxpayer
- The situation that emerges now is that two divisional benches of the Tribunal have interpreted the SB ruling differently. In case of BMW India, the Tribunal opined that SB ruling was applicable to the facts of a licensed manufacturer and not to the facts of a distributor. However, in Casio India's case, the Tribunal espoused the 14 parameters laid down by the SB ruling and inferred that the SB ruling is applicable to manufacturers as well as distributors irrespective of their functional and risk profile
- The fundamental question that needs to be asked is, what utility would the 14 parameters (laid down by the SB ruling) serve if, in each and every case, the revenue would compare the AMP spend of the taxpayer with that of independent comparables, irrespective of the taxpayer being a distributor

or manufacturer, without taking cognisance of its risk profile. In such a scenario, the whole issue would be reduced to a mechanical calculation wherein overseas brand owners would be asked to compensate the Indian AE for AMP expenses even if they have already reduced import prices as a compensation for the marketing effort of the taxpayer (Indian AE).

- With the cloud of uncertainty on the issue of marketing intangibles hovering over the Transfer Pricing litigation arena, taxpayers grappling with this issue may look beyond the normal litigation process to resolve these issues. The alternative mechanisms that can be particularly useful are Advance Pricing Agreements (APA) and Mutual Agreement Procedure (MAP). In bilateral APA and MAP, the revenue officials of other countries can work along with the Indian revenue authorities by bringing out the economic reality involved, based on the facts of the case, and not apply the principle in an isolated manner as if it were part of the Indian TP regulations.

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