ITAT rejects 'bright line test' for AMP expenditure; follows ratio of High Court in case of 'Sony Ericsson'

Summary – The Delhi ITAT in a recent case of Perfetti Van Melle India (P.) Ltd., (the Assessee) held that Following Order passed by jurisdictional High Court, it was to be held that TPO could not make addition to assessee's ALP in respect of AMP expenses incurred on behalf of AE by working out non-routine AMP expenses on basis of bright line test

Facts

- The assessee, an Indian company, was a subsidiary of PVM. It was engaged in manufacturing a variety of confectionary products from its factories in different states.
- During relevant year, assessee entered into various international transactions with its AE.
- In transfer pricing proceedings, TPO, noticed that the assessee incurred Advertisement, Marketing and Promotion (AMP) expenses to the tune of Rs. 183.73 crores. To determine the ALP of the international transaction of AMP expenses, the TPO chose certain comparable companies. By applying the bright line test, he worked out the non-routine AMP expenses in excess of bright line at Rs. 152.61 crores. Additing mark-up of 18.36 per cent, he worked out a transfer pricing adjustment of Rs. 180.63 crores.
- The DRP confirmed the addition made by TPO.
- On appeal :

Held

- It is an admitted position that the assessee under consideration is a `Manufacturer' and not a 'Distributor' (high or low/no risk). The Special Bench of the Tribunal in the case of *LG Electronics India (P.) Ltd.* v. *Asstt. CIT* [2013] 140 ITD 41/29 taxmann.com 300, by its majority decision, without drawing any distinction between manufacturers and distributors, has held, *inter alia*, that AMP is a transaction and also an international transaction within the meaning of section 92B and that the TPO has jurisdiction to compute the ALP of this international transaction despite the same not having been specifically referred by the Assessing Officer.
- On the question of determination of the ALP of this international transaction, the Special bench approved the application of bright line test for working out the amount of non-routine AMP expenses and held that the ALP of AMP expenses should be determined on Cost plus method by treating AMP transaction as a separate and distinct from other international transactions. It further held that the selling expenses directly incurred in connection with the sales do not lead to brand promotion and hence should not be brought within the overall ambit of AMP expenses. The Special bench laid down certain parameters to be taken into consideration for determining the ALP of AMP

expenses. In the ultimate analysis, the matter was sent back to the TPO/Assessing Officer for undertaking the exercise afresh in the light of its directions.

- Following the said special bench order, various benches of the Tribunal decided several cases involving AMP expenses, restoring the matter to the file of Assessing Officer/TPO for deciding this issue in conformity with the directions given by the Special Bench in *LG Electronics India (P.) Ltd.* (*supra*). Several assessees as well as the revenue preferred their respective appeals before the High Courts against the tribunal orders following the Special bench order. A batch of appeals in relation to `Distributors' (not Manufacturers) led by *Sony Ericsson Mobile Communications India (P.) Ltd.* v. *CIT* [2015] 231 Taxman 113/55 taxmann.com 240 (Delhi) has been disposed of by Delhi High Court, delivering judgment on 16-3-2015, upholding the majority view of Special Bench in *LG Electronics India (P.) Ltd.* (*supra*) treating AMP as an international transaction and also conferring jurisdiction in the TPO to determine the ALP of the international transaction of AMP expenses.
- Dealing with the computation of ALP of such transactions by a Distributor, the High Court has held, *inter alia*, that the international transaction of AMP expenses should be bundled/aggregated with other international transaction carried out by the assessee as a distributor, who either simply acts an agent of manufacturer or purchases goods from the manufacturer for resale at his own account. The High Court held that where the TNMM has been applied as the most appropriate method by a distributor, which method has not been disturbed by the TPO, then, the international transaction of AMP and distribution activities should be clubbed.
- It further held that for determining the ALP of such transactions under a combined approach, only such comparables should be chosen which conform to the AMP functions and other distribution functions conducted by the assessee. If there is some difference in the functions under these international transactions, including that of AMP, between the assessee and the comparables, then, suitable adjustment should be made to bring both the transactions at par.
- If probable comparables are not performing similar functions as done by the assessee and no adjustment is possible for bringing the international transactions of the assessee in an aggregate manner at par with those undertaken by the comparables, then, segregation should be done and the international transaction of AMP spend should be separately processed under the transfer pricing provisions for the purposes of determining its ALP separately. In such a determination of ALP of AMP expenses in a segregated manner, proper set off on account of excess purchase price adjustment should be allowed. The view taken by the Special bench of the Tribunal in segregating routine and non-routine expenses on the basis of bright line test has been set aside by the High Court. Further, the decision taken by the Special Bench to the effect that the expenses concerned with the sales, such as, rebates and discounts *etc.*, should be excluded from the ambit of AMP expenses, has been upheld.
- One can summarize the relevant position emanating from the judgment of the High Court, as under :—

- AMP expense is an international transaction;
- The TPO has jurisdiction to determine the ALP of the international transaction of AMP expenses;
- Inter-connected international transactions can be aggregated and section 92(3) does not prohibit the set-off;
- AMP is a separate function. An external comparable should perform similar AMP functions;
- Bright line test could not be applied to work out non-routine AMP expenses for benchmarking;
- ALP of AMP expenses should be determined preferably in a bundled manner with the distribution activity;
- For determining the ALP of these transactions in a bundled manner, suitable comparables having undertaken similar activities of distribution of the products and also incurring of AMP expenses, should be chosen.
- The choice of comparables cannot be restricted only to domestic companies using any foreign brand;
- If no comparables having performed both the functions in a similar manner are available, then, suitable adjustment should be made to bring international transactions and comparable transactions at par;
- If adjustment is not possible or comparable is not available, then, the TNMM on entity level should not be applied;
- In the above eventuality, international transaction of AMP should be viewed in a de-bundled manner or separately;
- In separately determining the ALP of AMP expenses, the TPO is free to choose any other suitable method including Cost plus method [Para 194(xiii)];
- In so making a TP adjustment on account of AMP expenses, a proper set off/purchase price adjustment should be allowed from the other transaction of distribution of the products;
- Selling expenses cannot be considered as part of AMP expenses.

- The bright line test, disapproved by the High Court, primarily concentrates on the quantitative aspects of the *AMP expenses* alone. It overlooks the examination of the *AMP functions* carried out by the assessee on one hand and the comparables on the other. The High Court in *Sony Ericsson Mobile Communications India (P.) Ltd.* (*supra*), has held that AMP expense is a separate international transaction and also bright line test is not applicable for determining the ALP of AMP expenses. The manner for the determination of the ALP of the distribution activity and AMP activity has also been set out by the High Court to be conducted, firstly, in a bundled manner by considering the distribution and AMP *functions* performed by the assessee as well as the probable comparables, and if probable comparables having performed both the functions are not available, then to determine the ALP of AMP expenses in a segregated manner. As such, it becomes immensely important to

separately examine the distribution activity and AMP *functions* undertaken by the assessee as well as probable comparables. It is vital to highlight the difference between the AMP expenses and AMP functions. Whereas the AMP functions are the means by which the AMP activity is performed, the AMP expenses are the amount spent on the performance of such means (functions). To put it simply, an examination of *AMP functions* carried out by the assessee and the probable comparables is *sine qua non* in the process of determination of the ALP of the international transaction of AMP spend, either in a segregate or an aggregate manner. What High Court has held is to bundle the distribution activity with the AMP activity, being two separate but connected international transactions, for the purposes of determination of the ALP of both these international transactions in a combined manner.

- The assessee argued that the assessee applied TNMM in respect of export of raw materials/finished goods and import of raw material from manufactured stock/finished goods. It submitted that since the profit margin declared by the assessee from such international transactions favourably compared with the average margin of the comparables, which fact has not been disputed by the TPO, no adjustment should be made on account of AMP expenses because such expenses stand subsumed in the overall operating profit. The argument of the assessee, if taken to a logical conclusion, will make the AMP spend a non-international transaction, which, is contrary to the verdict of the Delhi High Court in *Sony Ericsson Mobile Communications India (P.) Ltd.* (*supra*).
- Once AMP expense has been held to be an international transaction, it is, but, natural that the functions performed by the assessee under such a transaction need to be compared with similar functions performed by a comparable case. If AMP functions performed by the assessee turn out to be different from those performed by a probable comparable company, then, an adjustment is required to be made so as to bring the AMP functions performed by the assessee as well as the comparable, at the same pedestal. If one concurs with the contention of the assessee that the addition on account transfer pricing adjustment of AMP expenses be deleted without any examination of the AMP functions carried out by the assessee as well as comparables, this will amount to snatching away the tag of international transaction from AMP expenses, assigned by the High Court. What High Court has held in the judgment is that the distribution activity and AMP expenses are two separate but related international transactions. It is only for the purposes of determining their ALP that these two should be aggregated. The process of such aggregation does not take away the separate character of the AMP transaction, *albeit* related.
- An analysis and examination of the distribution and AMP functions carried out by the assessee must be necessarily done in the first instance, which should be then compared with similar functions performed by some probable comparables. If the distribution and AMP functions performed by the assessee turn out to be different from those performed by probable comparables, then, a suitable adjustment should be made to the profits of the comparable so as to counterbalance the effect of such differences. If however differences exist in such functions, but no adjustment can be made, then, such probable comparable should be dropped from the list of comparables. If, in doing this

exercise, there remains no company doing comparable distribution and AMP functions, then, both the international transactions are required to be segregated and then examined on individual basis by finding out probable comparables doing such separate functions similarly. For the international transaction of AMP spend, this can be done by, firstly, seeing the AMP functions actually performed by the assessee and then comparing it with the AMP functions performed by a probable comparable. If both are found out to be similar, then the matter ends and a comparable is found and one can go ahead with determining the ALP of such a transaction.

- If the AMP functions performed by the two entities are found to be different, then adjustment is required to be made in the case of a probable comparable, so as to make it uniform with the assessee. The assessee may have possibly done, say, four different AMP functions as against the probable comparable having done, say, only three. In such a scenario, again the adjustment will be warranted. In another situation, the AMP functions performed by the assessee and probable comparable may be similar but with varying standards, which will also call for an adjustment. Crux of the matter is that the AMP functions performed by the assessee must be similar to those done by the comparable, in the same manner as such functions are compared in any other international transaction. However, in computing ALP of AMP spend, the adjustment or set off, if any, available from the distribution function, should be allowed.
- The essence of the judgment in the case of *Sony Ericsson Mobile Communications India (P.) Ltd.* (*supra*) is that the two international transactions of distribution and AMP should be examined on the touchstone of transfer pricing provisions, but on an aggregate basis. Determining the ALP of two transactions in an aggregate manner postulates making a comparison of both the functions of distribution and AMP carried out by the assessee with the comparables, so that surplus from the distribution activity could be adjusted against the deficit in the AMP activity. The High Court has nowhere laid down that the AMP functions performed by the assessee should not be compared with those performed by the comparable parties. On the contrary, it turned down the contention raised by the assessee urging for not treating AMP as a separate function. Thus argument on behalf of the assessee is flawed and fallacious for several reasons.
- There are inherent flaws in the said argument. It is manifest that comparison of AMP functions is vital which cannot be dispensed with. If one go as a step further with the alternative prescription of the judgment that if ALP of both the transactions of distribution and AMP cannot be determined in a combined manner, then the ALP of AMP function should be separately done. The submission advanced by the assessee of considering the profit on an entity level without making comparison of AMP functions done by the assessee as well as the comparable, will render this alternative approach incapable of compliance. Canvassing such a view as argued on behalf of the assessee amounts to treating AMP spend as a non-international transaction, which is patently incapable of acceptance.
- The fact remains that as per the verdict of the High Court, the AMP spend is an international transaction, which is required to be processed under Chapter X of the Act by taking into account the AMP functions performed by the assessee and then comparing such functions with those performed

by comparable entities. This can be done only by mandatorily making a comparison of the AMP functions performed by the assessee and comparables and then making an adjustment, if any, due to differences between the two, so that the AMP functions performed by the assessee and comparable are brought to a similar platform.

- A perusal of the sub-clause (iii) of rule 10B(1)(e) divulges that net profit margin under a comparable uncontrolled transaction as determined under sub-clause (ii) should be: "adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions." It is only such adjusted net profit margin in sub-clause (iii) of rule 10B(1)(e) which is compared with the net profit margin realized by the assessee as per the mandate of sub-clause (iv) of rule 10B(1)(e).
- Sub-rule (2) of rule 10B provides that 'for the purposes of sub-rule(1)', the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely - (a) the specific characteristics of the property transferred or services provided in either transaction ; (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions ; (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions ; (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.
- Sub-rule (3) of rule 10B stipulates that an uncontrolled transaction shall be comparable to an international transaction if (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market ; or (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.
- A comparative study of sub-rules (1), (2) and (3) of rule 10B makes it palpable that the international transaction and the uncontrolled transaction with which comparison is sought to be made for determining the ALP, in the first instance, must have overall similar characteristics. It is vivid that if the goods/services are different, then no effective comparison can be made. Once the goods/services under both the transactions are broadly similar but there is a difference in them because of certain specific characteristics; and/or the products/services in both the transactions are identical, but still there are certain differences due to the contractual terms or the geographical location *etc.*, then, a reasonably accurate adjustment should be made for eliminating the material effects of such differences so as to bring the international transaction and the comparable uncontrolled transaction on the same podium. If due to one reason or the other, no reasonable

accurate adjustment can be made due to such differences, then, such uncontrolled transaction should not be considered as a comparable transaction.

- It is discernible that the prescription of Rule 10B is in complete harmony with the *ratio* of the judgment in the case of *Sony Ericsson Mobile Communications India (P.) Ltd. (supra)*, to the effect that the AMP functions carried out by the assessee are required to be necessarily compared with the AMP functions carried out by a comparable entity in determining the AMP of ALP expenses. Difference between the functions, if capable of adjustment, should be given effect to in the profit rate of the comparable and if such difference cannot be adjusted, then, the probable comparable should be eliminated.
- In the instant case, the assessee is a `Manufacturer' and not a `Distributor'. The judgment in the case of *Sony Ericsson Mobile Communications India (P.) Ltd.* (*supra*) deals with a case of Distributor, though the initial discussion about the character of AMP spend as an international transaction and the jurisdiction of the TPO etc. are common to a distributor and also a manufacturer. Similarly there are some other observations in this judgment, which are common to both. Though this judgment lays down at length some broader principles for the determination of ALP of AMP expenses in the case of a `Distributor', still certain principles dealing exclusively with the determination of the ALP of AMP expenses in the case of a `Manufacturer', have also been laid down.
- The core of said discussion is that in the case of a 'Manufacturer', the international transactions concerned with the manufacturing activity cannot be aggregated with the AMP activities as both are separate and distinct. Once both are held to be separate and TNMM is not to be applied, the only thing which remains is that the AMP transaction should be separately and independently processed under the Chapter X of the Act as per any suitable method (other than TNMM) including Cost plus method, but by excluding the selling expenses from the overall base of AMP expenses.
- Turning to the facts of the case, the TPO/Assessing Officer has followed the Special bench decision in *LG Electronics India (P.) Ltd.* (*supra*) for determining the ALP of AMP expenses. There is no discussion about the AMP functions carried out by the assessee or comparables. Now since the Special bench order has been partly modified by the Delhi High Court, including the non-applicability of the bright line test, and no material had been placed on record by the assessee to, firstly, demonstrate the AMP functions carried out by the assessee and then, to compare such functions with those done by comparables, this issue cannot be decided of this stage.
- Under such circumstances, the impugned order is set aside and the matter is remitted to the file of the Assessing Officer/TPO for deciding it afresh as per law. In this fresh exercise, the TPO will follow the parts of the judgment in *Sony Ericsson Mobile Communications India (P.) Ltd.* (*supra*) as are common to both Manufacturers and Distributors; apply the parts of the judgment as are applicable to a 'Manufacturer'; and ignore the parts of the judgment which pertain exclusively to a 'Distributor'. Needless to say, the assessee will be allowed a reasonable opportunity of hearing in such fresh proceedings.
- In the result, the appeal is allowed for statistical purposes.