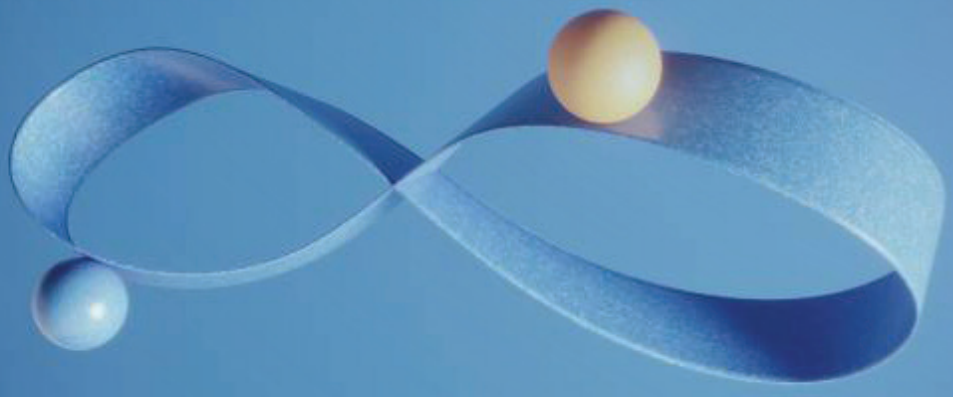


Delhi High Court ruling on Transfer Pricing implications of AMP expenditure and forex losses

The issue of AMP expenditure has been an issue which has had the judiciary divided. While there are certain rulings which have ruled in favour of the Tax Department and advocated the use of 'Bright Line' Test, there are other rulings which have held that the Bright Line Test cannot be applied.

The above issue was again placed for determination before the Delhi HC in the Case of Samsung India,[1] wherein the major issues which were taken up before the HC was as follows

- **Whether advertisement, marketing and promotion ('AMP') expenditure constitutes as an international transaction?**
- **Whether foreign exchange gain/loss arising from international transactions was to be considered as an item of operating revenue/cost and not as a non-operating revenue/cost?**

Background:

The appellant Samsung India Electronics Pvt. Ltd. (SIEL or Appellant) was a company primarily engaged in the business of manufacture and sale of consumer electronics and home appliances goods. The appellant company is a part of the Samsung group of companies and a wholly owned subsidiary of Samsung Electronics Co. Ltd. Korea ('SEC').

The Appellant incurred certain AMP expenditure during the year concerned and failed to disclose the same in Transfer pricing report. The Transfer Pricing Officer ('TPO') had determined the Arm's Length Price ('ALP') of the transaction stating it as International Transaction with the help of Bright Line Test ('BLT').

Aggrieved by the same, the appellant had filed appeal before the First Appellate Authority and then subsequently before the Income Tax Appellate Tribunal (ITAT). ITAT had issued order in favour of the the Appellant and thereafter the Tax Department challenged this order before the Delhi High Court (Delhi HC).

Here are the key questions of law placed before the Delhi HC:

- Whether the ITAT was justified in holding that the Advertising, Marketing, and Promotion (AMP) expenditure does not constitute an international transaction?
- Whether the ITAT was correct in stating that the Brightline Test is not mandated by law and cannot

[1]PCIT VS SAMSUNG INDIA ELECTRONICS (P.) LTD. HIGH COURT OF DELHI, IT APPEAL NO. 453 OF 2024† AUGUST 22, 2024

be used to determine price but can only be used as an economic tool for determining costs in transfer pricing?

- Whether the ITAT was right in observing that under the Transactional Net Margin Method (TNMM), AMP expenditure cannot be segregated for benchmarking?
- Whether the ITAT was correct in stating that a protective adjustment to preserve revenue interests cannot be made when the issue of AMP is still pending before the Supreme Court?
- Whether the ITAT erred in not appreciating that the ALP should remain unaffected by foreign exchange fluctuations and other post-transaction events?
- Whether the ITAT erred in not recognizing that the TPO followed Rule 10B(3) by treating foreign exchange fluctuations and provisions as non-operating costs/ revenues to ensure a consistent basis for comparison?

The Hon'ble High Court with regard to the Question of facts stated in Sl. No 1 to 3 hereinabove relied on the judgement in the case of **Sony Ericsson Mobile Communications India Pvt Ltd. ('Sony India') v. Commissioner of Income-Tax 2015 SCC OnLine Del 8083.**

Brief gist of the judgement provided in the Sony Ericsson (Supra):

- This common judgment disposed of the appeals and cross-appeals by the assessee and the Revenue in which one of the primary issues that emanates for consideration is whether advertisement, marketing and sale promotion expenditure beyond and exceeding the bright line is a separate and independent international transaction undertaken by the resident Indian assessee towards brand building for the brand owner, i.e. the foreign Associated Enterprise.
- In the transfer pricing report, the company (the assessed) acknowledged that its group companies (the associated enterprises or AEs) owned important and valuable intellectual property, like brand names, trademarks, and logos. However, the assessed company itself did not own any significant or valuable non-routine intangible assets. The assessed company's main role was as an importer. It focused on distribution and marketing by reselling imported handsets.
- The TPO had erred in holding that AMP expenses would constitute as an international transaction and determined the ALP using the BLT, which is not a prescribed computation method under Income Tax Act, 1961 and thus contrary to law.
- The TPO made an adjustment w.r.t the AMP expenses incurred in excess of bright line limit, computed by taking the ratio of the AMP expenditure to sales of the Assessee and average mean of the AMP expenditure to sales ratio of uncontrolled comparables (routine domestic distributors) were taken as comparable uncontrolled price.
- The AMP expenditure was divided into two parts:
  - **Routine expenses,** which was the average mean of the said ratio multiplied by the sales amount of the Assessee
  - **Non-routine expenses,** which was in excess of the average mean of the ratio multiplied by the sales amount, this non-routine AMP expense was then marked up with 15% for adjustment, and thereafter the ALP was recomputed.
- However, the Delhi HC had issued order in favour of assessee, by ruling that BLT to be invalid in law, while still considering the expenses as international transaction.
- Subsequently, in further hearing i.e. in the order dated 28.01.2016, it was argued by the assessee that the AMP expenses was a function performed by it, which was part of role and responsibility and that both the assessee and its foreign AE benefit from such expenditure.
- Therefore, the court mentioned that the previous decision where it was considered as international transaction "Sony ericsson (Supra)", the partied involved did not argue about whether there was an international transaction. However, in that current case the assessee had raised a specific question about whether an international transaction exists. This question was presented to both the Dispute Resolution Panel (DRP) and the Income Tax Appellate Tribunal (ITAT).
- Thereafter, the case was remanded back to the ITAT to decide afresh while issuing the order in favour of assessee.

SO, HOW DOES BRIGHT LINE TEST WORK?

	Computation of TP adjustment w.r.t AMP expenses	Amount (Rs.)
A	Value of Gross Sales	1,00,00,00,000
B	AMP/Sales of comparables	3.35%
C	Amount that represents bright line (A*B)	3,35,00,000
D	Expenditure on AMP by assessee	20,00,00,000
E	Expenditure in excess of bright line (D-C)	16,65,00,000
F	Mark-up at 15% (E*15%)	2,49,75,000
G	Reimbursement that assessee should have received (E+F)	19,14,75,000
H	Reimbursement actually received NIL	0
I	Adjustment to assessee's income (vG-H)	19,14,75,000

BRIGHT-LINE TEST AND ITS HISTORY:

- A tricky issue under the Indian Transfer Pricing regulations is the treatment of Advertising, Marketing, and Promotion (AMP) expenses that Indian companies pay for products from their foreign partners. This area is ambiguous because there aren't clear laws, and understanding comes mainly from Court cases.
- The issue began with a U.S. Tax Court case about DHL Corporation, following new rules introduced in 1968 known as the "Developer Assister Rules." These rules state that a company spending money on marketing (the developer) can be seen as the economic owner of the brand, even if it doesn't legally own it. The legal owner of the brand (the assister) doesn't need to pay the developer for using the brand.
- The reasoning is that when a company invests in marketing, it takes on financial risk, giving it a claim to the brand's value, regardless of legal ownership. So, ownership isn't just about who has the legal title; it's also about who is financially supporting the brand.
- In the U.S., Transfer Pricing rules differentiate between "Routine" expenses (regular costs) and "non-routine" expenses (specific marketing costs). This distinction is crucial for deciding how much a domestic company should be compensated for its marketing efforts.
- In the DHL case, the Court introduced the Bright Line Test (BLT) to help identify these two types of expenses. Non-routine expenses are those specifically for marketing, while routine expenses are everyday costs a distributor incurs.
- This distinction helps determine the economic ownership of the brand based on marketing spending. It evaluates whether the marketing expenses go beyond normal costs and significantly enhance the brand's value, which impacts how much the domestic company should be paid for its marketing work.

THE UNRESOLVED ISSUE OF AMP EXPENSES UNDER TRANSFER PRICING:

Since the very beginning, the issue of AMP has been mired in controversy. One of the primary issues has been that, whether such a transaction would at all qualify as an international transaction or not?

The issue of Advertising, Marketing, and Promotion (AMP) expenses in Transfer Pricing has been addressed in several important Court cases in India.

- First Maruti Judgment: In the case of **Maruti Suzuki India Ltd. (2010),** the Delhi High Court ruled that AMP expenses were international transactions under Indian tax law. It stated that Indian companies were simply using the brands of their foreign partners for their business. This decision was challenged and eventually overruled by the Hon'ble Supreme Court in **Maruti Suzuki India Ltd. v. Addl. CIT (2011).**

  However instead of laying the matter to stay at rest, the issue was rekindled by the ITAT in the case **LG Electronics India (2013)** herein below, by passing the judgement in the favour of revenue.
- LG Electronics Case: Later, in **LG Electronics India (2013),** a **Special Bench of the ITAT** (Income Tax Appellate Tribunal) the tax authorities could adjust transfer pricing based on the Bright Line Test (BLT) for AMP expenses, treating them as international transaction.
- Sony Ericsson Case: This decision was later examined by the Delhi High Court in the case of **Sony Ericsson Mobile Communications India (2015).** The High Court partially overruled the LG Electronics decision. It stated that while AMP functions could be considered as an international transaction, the application of the BLT was not valid inferring that the same is not an appropriate yardstick for determining the existence of an international transaction much less for calculating the ALP. It ordered a fresh analysis of how to determine the arm's length price (ALP) for these expenses.
- Second Maruti Judgment: In another case, **Maruti Suzuki India Ltd. v. CIT (2015),** the Delhi High Court ruled that simply benefiting from AMP expenses doesn't automatically mean there's an international transaction.
- Bausch & Lomb Case: Other cases, like **Bausch & Lomb Eyecare (2016),** also concluded that AMP expenses were not international transactions and highlighted the lack of guidelines for adjusting these expenses.
- Recent Sony Mobile Case: More recently, the ITAT in the **Sony Mobile Communications** case noted that the AMP expenses did not add value to the Sony Ericsson brand and should be viewed as expenses for brand maintenance rather than brand building. The company had a profit margin significantly higher than comparable companies, suggesting no need for additional adjustments to the ALP

  Sony Ericsson judgement (Supra) provides valuable guidance, so far as it overruled the BLT. The BLT is fraught with difficulties and arbitrariness, both in terms of compatibility with the statute and commercial considerations.

Overall, while some rulings suggest that AMP expenses can be treated as an 'International Transaction., others argue against this idea. Many of these decisions are now Sub-Judice before the Supreme Court, which will ultimately clarify the situation.

Whether foreign exchange gain/loss arising from international transactions was to be considered as an item of operating revenue/cost and not as a non-operating revenue/cost?

This question is answered based on the judgement given in the Case law ***(Ameriprise India (P.) Ltd. v. Asstt. CIT (2016)*** Decision by the Income Tax Appellate Tribunal (ITAT) regarding the treatment of foreign exchange gains and losses in relation to international transactions.

- The ITAT noted that the foreign exchange gain earned by the Assessee was related to trading items from international transactions. Therefore, the foreign exchange loss, which also resulted from trading items, should not be considered a non-operating loss.
- The Dispute Resolution Panel observed that the service agreement between the Associated Enterprise (AE) and the Assessee specified that invoices should be raised on Ameriprise USA based on a cost-plus pricing methodology.
- Based on these observations, the ITAT held that the Assessing Officer (AO) was not justified in treating the foreign exchange loss as a non-operating cost.
- The Delhi High Court found no substantial question of law and dismissed the appeal

  Therefore, the foreign exchange gain/loss arising from international transactions was to be considered as an item of operating revenue/cost and not as a non-operating revenue/cost.

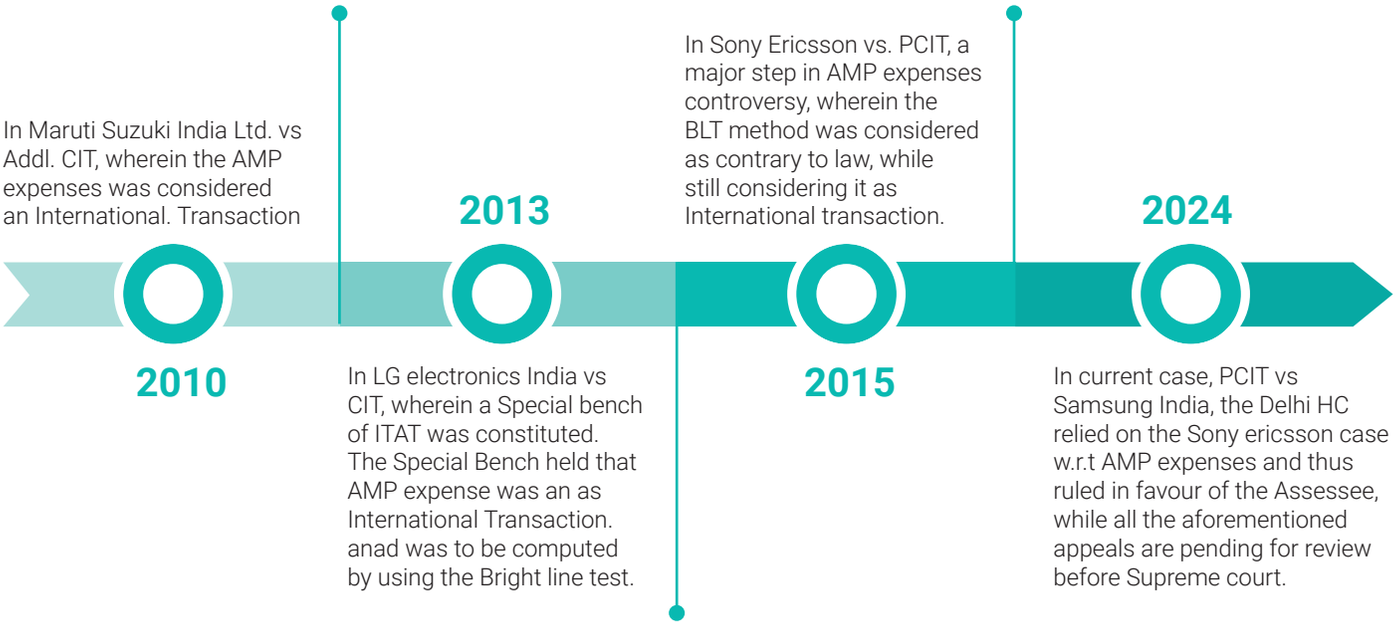
Conclusion

The issue of AMP expenses has had a chequered litigation history, wherein the Judiciary have taken different views on this matter. The crucial issues which arise, are whether AMP expenses, can be considered as an 'International Transaction' especially when the TNMM method is applied, considering TNMM method is an all-encompassing method, wherein the net margin is computed on an overall basis and the transactions are not looked at individually.

The second issue which arises is, even if AMP expense is considered to be an 'International Transaction', how is the benchmarking to be done for such transactions. While Courts in India have applied the internationally accepted' Bright Line Test', there are ambiguities around this method considering the local transfer pricing regulations do not prescribe this test and further benchmarking AMP expense is a complex process, considering companies may spend differently on AMP basis their position in the market and competition which they face.

In addition, to the AMP issue, the above ruling also provides valuable guidance on the issue of whether forex loss can be considered as an operating cost. While the High Court in this case, has ruled in favour of the assessee, it is critical to note that the Intercompany agreement, should clearly provide for the treatment of forex loss, i,e. whether the same can be considered as part of the operating cost.

Synopsis of the AMP issue and the Judicial Rulings



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