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HC direct AO to examine whether AMP exp. was incurred by 'Yum Restaurant' to create marketing intangible for its AE

Summary – The High Court of Delhi in a recent case of Yum Restaurants (India) (P.) Ltd., (the Assessee) held that where TPO made addition to assessee's ALP in respect of incurring AMP expenses on behalf of its AE, matter was to be remanded back for disposal afresh with a direction to firstly ascertain if any part of AMP expenses was for purpose of creating marking intangibles for AE

Facts

- The assessee, was part of the 'Yum Restaurants Group' with its ultimate holding company being 'Yum USA'. 99.99 per cent of shares of assessee were initially held by 'Yum Asia'. Subsequently, the shares of assessee were held by 'Yum Singapore' pursuant to a restructuring within the group.
- A company namely 'Yum Marketing' was formed as a wholly owned subsidiary of assessee for carrying out advertising, marketing and promotion ('AMP') activities on behalf of assessee, its franchisees and business associates in India.
- In terms of agreement, assessee required to contribute a fixed percentage from its 'equity stores' as its contribution towards 'AMP' activities.
- In transfer pricing proceedings, the TPO opined that assessee had not been adequately compensated for the AMP expenses incurred by it. The TPO took a view that assessee had to be separately compensated by the AE due to creation of marketing intangibles. Further, a markup of 9.98 per cent should be applied to the above sum. Consequently, the TPO made certain addition to the arm's length price ('ALP') of the 'international transaction' on 'account of contribution of brand building expenses'.
- The DRP confirmed said addition.
- The Tribunal following the decision of its Special Bench in *LG Electronics India (P.) Ltd.* v. *Asstt. CIT* [2013] 140 ITD 41/29 taxmann.com 300 (Delhi) (SB) directed the Assessing Officer to decide the question afresh after allowing the assessee a reasonable opportunity of being heard.
- On appeal:

Held

- It must be mentioned at this stage that prior to the filing of the instant appeals against the order of the Tribunal, this Court in *Sony Ericsson Mobile Communication India (P.) Ltd.* v. *CIT* [2015] 374 ITR 118/231 Taxman 113/55 taxmann.com 240 (Delhi) decided the correctness of the decision of the Special Bench of the Tribunal in *LG Electronics India (P.) Ltd.* (*supra*). The said decision was delivered in a batch of appeals concerning Indian entities who were distributor of products manufactured by their respective foreign AEs.

- The important conclusions of the Division Bench in *Sony Ericsson* (*supra*) relevant to the case on hand were as under:

(i) The Court concurred with the majority of the Special Bench of the Tribunal in *LG Electronics India (P.) Ltd.* (*supra*) *qua* the applicability of 92CA(2B) and how it cured the defect inherent in 92CA(2A). The issue concerning retrospective insertion of 92CA(2B) was decided in favour of the revenue.

(ii) AMP expenses were held to be international transaction as this was not denied as such by the assessees therein.

(iii) Chapter X and section 37(1) of the Act operated independently. The former dealt with the ALP of an international transaction whereas the latter deals with the allowability/disallowability of business expenditure. Also, once the conditions for applicability of Chapter X were satisfied nothing shall impede the law contained therein to come into play.

(iv) Chapter X dealt with ALP adjustment whereas section 40A(2)(b) dealt with reasonability of quantum of expenditure.

(v) TNMM applied with equal force on single transaction as well as multiple transactions as per the scheme of Chapter X and the TP Rules. Thus, the word 'transaction' would include a series of closely linked transactions.

(vi) The TPO/AO could overrule the method adopted by the assessee for determining the ALP and select the most appropriate method. The reasons for selecting or adopting a particular method would depend upon functional analysis comparison, which required availability of data of comparables performing of similar or suitable functional tasks in a comparable business. When suitable comparables relating to a particular method were not available and functional analysis or adjustment was not possible, it would be advisable to adopt and apply another method.

(vii) Once the Assessing Officer/TPO accepted and adopted the TNMM, but chose to treat a particular expenditure like AMP as a separate international transaction without bifurcation/segregation, it would lead to unusual and incongruous results as AMP expenses was the cost or expense and was not diverse. It was factored in the net profit of the inter-linked transaction. The TNMM proceeded on the assumption that functions, assets and risks being broadly similar and once suitable adjustments have been made, all things get taken into account and stand reconciled when computing the net profit margin. Once the comparables pass the functional analysis test and adjustments have been made, then the profit margin as declared when matches with the comparables would result in affirmation of the transfer price as the arm's length price. Then, to make a comparison of a horizontal item without segregation would be impermissible.

(viii) The Bright Line Test (BLT) was judicial legislation. By validating the BLT the Special Bench in *LG Electronics India (P.) Ltd.* (*supra*) went beyond Chapter X of the Act. Even international tax jurisprudence and commentaries do not recognise BLT for bifurcation of routine and non-routine expenses.

(ix) Segregation of aggregated transactions requires detailed scrutiny without which there shall be no segregation of a bundled transaction. Set off of transactions segregated as a single transaction is just and equitable and not prohibited by Section 92(3). Set-off is also recognized by international tax experts and commentaries.

(x) Segregation of bundled transactions shall be done only if exceptions laid down in *CIT* v. *EKL Appliances Case* [2012] 345 ITR 241/209 Taxman 200/24 taxmann.com 199 (Delhi) are justified. Re-categorisation and segregation of transactions are different exercises; former would require separate comparables and functional analysis.

(xi) Economic ownership of a brand would only arise in cases of long-term contracts and where there is no negative stipulation denying economic ownership. Economic ownership of a brand or a trade mark when pleaded can be accepted if it is proved by the assessee. The burden is on the assessee. It cannot be assumed.

(xii) The RP Method loses its accuracy and reliability where the reseller adds substantially to the value of the product or the goods are further processed or incorporated into a more sophisticated product or when the product/service is transformed. RP Method may require fewer adjustments on account of product differences in comparison to the CUP Method because minor product differences are less likely to have material effect on the profit margins as they do on the price.

(xiii) Determination of cost or expense can cause difficulties in applying cost plus (CP) Method. Careful consideration should be given to what would constitute cost *i.e.* what should be included or excluded from cost. A studied scrutiny of CP Method would indicate that when the said method is applied by treating AMP expenses as an independent transaction, it would not make any difference whether the same are routine or non-routine, once functional comparability with or without adjustment is accepted.

(xiv) The task of arm's length pricing in the case of tested party may become difficult when a number of transactions are interconnected and compensated but a transaction is bifurcated and segregated. CP Method, when applied to the segregated transaction, must pass the criteria of most appropriate method. If and when such determination of gross profit with reference to AMP transaction is required, it must be undertaken in a fair, objective and reasonable manner.

(xv) The marketing or selling expenses like trade discounts, volume discounts, *etc.* offered to sub-distributors or retailers are not in the nature and character of brand promotion. They are not directly or immediately related to brand building exercise, but have a live link and direct connect with marketing and increased volume of sales or turnover. The brand

building connect is too remote and faint. To include and treat the direct marketing expenses like trade or volume discount or incentive as brand building exercise would be contrary to common sense and would be highly exaggerated. Direct marketing and sale related expenses or discounts/concessions would not form part of the AMP expenses.

(xvi) The prime lending rate cannot be the basis for computing mark up under rule 10B(1)(c) of the Income-tax Rules, 1962, as the case set up by the revenue pertains to mark up on AMP expenses as an international transaction. Mark up as per sub-clause (ii) to rule 10B(1)(c) would be comparable gross profit on the cost or expenses incurred as AMP. The mark up has to be benchmarked with comparable uncontrolled transactions or transactions for providing similar service/product.

(xvii) An order of remand to the Tribunal for *de novo* consideration would be appropriate because the legal standards or ratio accepted and applied by the Tribunal was erroneous. On the basis of the legal ratio expounded in this decision, facts have to be ascertained and applied. If required and necessary, the assessed and the revenue should be asked to furnish details or tables. The Tribunal, in the first instance, would try and dispose of the appeals, rather than passing an order of remand to the Assessing Officer/TPO. An endeavour should be to ascertain and satisfy whether the gross/net profit margin would duly account for AMP expenses. When figures and calculations as per the TNM or RP Method adopted and applied show that the net/gross margins are adequate and acceptable, the appeal of the assessed should be accepted. Where there is a doubt or the other view is plausible, an order of remand for re-examination by the Assessing Officer/TPO would be justified. A practical approach is required and the Tribunal has sufficient discretion and flexibility to reach a fair and just conclusion on the ALP.

- In the appeal filed by assessee the questions urged for consideration broadly touch upon the issue of treatment of the AMP expenses of the international transactions.
- The revenue seeks remand to the Assessing Officer/TPO for a fresh decision on the issue concerning determination of the ALP of the international transactions involving AMP expenses in light of the decision of this Court in *Sony Ericsson Mobile Communication India P. Ltd.* (*supra*).
- After the decision in *Sony Ericsson Mobile Communication India (P.) Ltd.* (*supra*), the adoption of the BLT for determining the existence of an international transaction involving AMP expenses is no longer legally permissible. In that scenario, there would be a need for a detailed examination of the operating agreement between assessee, Yum Marketing and the franchisees to ascertain if any part of the AMP expenses was for the purpose of creating marking intangibles for the AE of assessee. It is only after an international transaction involving assessee and its AE in relation to AMP expenses is shown to exist, that the further question of determining the ALP of such international transaction would arise.

- It is not possible to state that the revenue has not placed any material to even *prima facie* show the existence of an agreement regarding AMP expenses. The question however remains whether it discloses an international transaction between assessee and its AE in regard to AMP expenses for creating of marketing intangibles for the AE. If it is shown to exist the further question would be whether it is at ALP. The submission on behalf of assessee that for said purpose, the franchise marketing model of JFL is an ideal comparable would then require to be considered.
- For the above reasons, without commenting one way or the other on the submissions of either the revenue or the assessee, the Court sets aside the impugned order the Tribunal and the corresponding orders of the Assessing Officer/TPO and the DRP as regards the issue of AMP expenses and remands the issue concerning the determination of the existence of an international transaction between the assessee and its AE involving AMP expenses and the further question of determination of its ALP to the Assessing Officer/TPO for a fresh decision in light of the judgment of this Court in *Sony Ericsson Mobile Communication India P. Ltd.* (*supra*).