* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

+ **ITA No. 16/2014**

Reserved on: 5th November, 2014

% **Date of Decision: 16th March, 2015**

Sony Ericsson Mobile Communications India Pvt. Ltd.
(Now known as Sony India Limited) ...Appellant

Through Mr. N. Venkataraman, Sr. Advocate with
Mr. Deepak Chopra and
Mr. Harpreet Singh Ajmani, Advocates.

Versus

Commissioner of Income Tax – III …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 70/2014

Discovery Communications India ..Appellant

Through Mr. M.S. Syali, Sr. Advocate with
Mr. Taran Deep Singh, Mr. Mayank Nagi,
Mr. Tarun Singh, Ms. Husnal Syali &
Mr. Harkunal Singh, Advocates.

Versus

Deputy Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 92/2014

Daikin Airconditioning India Pvt. Ltd. ..Appellant

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Deputy Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 93/2014

Daikin Airconditioning India Pvt. Ltd. ..Appellant

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Deputy Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 99/2014

Haier Appliances (India) P. Ltd. ....Appellant

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Deputy Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 100/2014

Haier Appliances (India) P. Ltd. ....Appellant

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 101/2014

Haier Appliances (India) P. Ltd. ....Appellant

Through Mr. Ajay Vohra, Sr. Advocate with

Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 109/2014

Reebok India Company Ltd. ....Appellant

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Addl. Commissioner of Income Tax …Respondent

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

ITA No. 132/2014

Commissioner of Income Tax …Appellant

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

Versus

Canon India Pvt. Ltd. ....Respondent

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

ITA No. 155/2014

Commissioner of Income Tax -III …Appellant

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

Versus

Sony Mobile Communication India Pvt.Ltd.
(Now known as Sony India Limited) .. Respondent

Through Mr. N. Venkataraman, Sr. Advocate with
Mr. Deepak Chopra and
Mr. Harpreet Singh Ajmani, Advocates.

ITA No. 213/2014

Commissioner of Income Tax -V …Appellant

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

Versus

Reebok India Co. Ltd. .... Respondent

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

ITA No. 214/2014

Commissioner of Income Tax -IV …Appellant

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

Versus

Daikin Airconditioning India Pvt. Ltd. ….Respondent

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

ITA No. 215/2014

Commissioner of Income Tax -IV …Appellant

Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

Versus

Daikin Airconditioning India Pvt. Ltd. ….Respondent

Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,

Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

ITA No. 218/2014

Commissioner of Income Tax -IV ...Appellant
Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates
Versus

Discovery Communication India ....Respondent
Through Mr. M.S. Syali, Sr. Advocate with
Mr. Taran Deep Singh, Mr. Mayank Nagi,
Mr. Tarun Singh, Ms. Husnal Syali &
Mr. Harkunal Singh, Advocates.

ITA Nos. 498/2014 & 618/2014

Commissioner of Income Tax -I ...Appellant
Through Mr. G.C. Srivastava, Advocate and
Mr. N.P. Sahni, Sr. Standing Counsel with
Mr. Nitin Gulati, Advocate
Versus

Casio India Co. P. Ltd. ....Respondent
Through Mr. Deepak Chopra and
Mr. Harpreet Singh Ajmani, Advocates

ITA No. 512/2014 & 513/2014

Casio India Co. P. Ltd. ...Appellant
Through Mr. Deepak Chopra and
Mr. Harpreet Singh Ajmani, Advocates
Versus

Commissioner of Income Tax ...Respondent
Through Mr. G.C. Srivastava, Advocate and
Mr. N.P. Sahni, Sr. Standing Counsel with
Mr. Nitin Gulati, Advocate

ITA No. 621/2014, 622/2014 & 642/2014

Commissioner of Income Tax -IV ...Appellant
Through Mr. G.C. Srivastava, Advocate with
Mr. Kamal Sawhney, Mr. Sanjay Kumar, Advs.

Versus

Haier Appliances India Pvt. Ltd. ….Respondent
Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

ITA No. 521/2013

Canon India Pvt. Ltd. …Appellant
Through Mr. Ajay Vohra, Sr. Advocate with
Mr. Mukesh Bhutani, Mr. Neeraj K. Jain,
Mr. Vishal Kalra, Ms. Vrinda Tulshan &
Mr. Rahul Yadav, Advocates

Versus

Deputy Commissioner of Income Tax ....Respondent
Through Mr. G.C. Srivastava, Advocate with
Mr. Rohit Madan, Mr. P. Roychaudhri,
Mr. Ruchir Bhatia and Mr. Akash Vajpai, Advocates

CORAM:
HON’BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE V. KAMESWAR RAO

SANJIV KHANNA, J.

This common judgment will dispose of these appeals and cross-appeals by the assessee and the Revenue in which one of the primary issue that emanates for consideration is whether advertisement, marketing and sale promotion expenditure (‘AMP’, for short) 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 (‘AE’, for short). Other core issues pertain to aspects of arm’s length pricing of international transactions.

2. The details of appeals and cross-appeals by the assessees and the Revenue and the assessment years involved are as under:

Assessment year	**ITA No.**	**Assessee**	**Cross Appeal by Revenue**
2008-09	16/2014	Sony Ericsson Mobile Communications India Pvt. Ltd / Sony Mobile Communication India Pvt. Ltd. *Now known as,* Sony India Ltd.	155/2014
2008-09	70/2014	Discovery Communications India	218/2014
2006-07	521/2013	Canon India Pvt. Ltd	132/2014
2008-09	92/2014	Daikin Air Conditioning (India) Pvt. Ltd	214/2014
2007-08	93/2014	Daikin Air Conditioning (India) Pvt. Ltd	215/2014
2008-09	99/2014	Haier Appliances Pvt. Ltd	642/2014
2006-07	100/2014	Haier Appliances Pvt. Ltd	621/2014
2007-08	101/2014	Haier Appliances Pvt. Ltd	622/2014
2008-09	109/2014	Reebok India Company	213/2014
2007-08	512/2014	Casio India Company Pvt. Ltd	618/2014
2008-09	513/2014	Casio India Company Pvt. Ltd	498/2014

The common substantial questions of law which are required to be dealt with in the appeals by the assessee read:

1. Whether the additions suggested by the Transfer Pricing Officer on account of Advertising/Marketing and Promotion Expenses (‘AMP Expenses’ for short) was beyond jurisdiction and bad in law as no specific reference was made by the Assessing Officer, having regard to retrospective amendment to Section 92CA of the Income Tax Act, 1961 by Finance Act, 2012.

2. Whether AMP Expenses incurred by the assessee in India can be treated and categorized as an international transaction under Section 92B of the Income Tax Act, 1961.

3. Whether under Chapter X of the Income Tax Act, 1961, a transfer pricing adjustment can be made by the Transfer Pricing Officer/ Assessing Officer in respect of expenditure treated as AMP Expenses and if so in which circumstances?

4. If answer to question Nos.2 and 3 is in favour of the Revenue, whether the Income Tax Appellate Tribunal was right in holding

> that transfer pricing adjustment in respect of AMP Expenses should be computed by applying Cost Plus Method.
>
> 5. Whether the Income Tax Appellate Tribunal was right in directing that fresh bench marking/comparability analysis should be undertaken by the Transfer Pricing Officer by applying the parameters specified in paragraph 17.4 of the order dated 23.01.2013 passed by the Special Bench in the case of LG Electronics India (P) Ltd.?

The common substantial questions of law which are required to be dealt with in the appeals by the Revenue read:

> 1. Whether the Income Tax Appellate Tribunal was right in distinguishing and directing that selling expenses in the nature of trade/volume discounts, rebates and commission paid to retailers/dealers etc. cannot be included in the AMP Expenses?

Additional question of law framed in ***CIT versus Reebok,*** ITA No.213/2014 reads:-

> Whether Income Tax Appellate Tribunal was right in setting aside/deleting transfer pricing adjustment made on account of payment of royalty to an associated enterprise?

A. **Background facts and assessments**

3. The assessed are subsidiaries of the foreign AEs. The assessed and the foreign AEs are all members of Multi-National Enterprises ('MNE', for short). During the relevant period, the assessed were engaged in distribution and marketing of imported and branded products, manufactured and sold to them by the foreign AEs resident abroad. Intangible rights in the brand-name/ trademark/ trade-name were owned by the foreign AEs. There is no dispute or *lis* that the assessed are AEs who had entered into controlled transactions with the foreign AEs. It is also uncontested that the controlled international

transactions can be made subject matter of the transfer pricing adjustment terms of Chapter X of the Income Tax Act, 1961 ('Act', for short).

4. In order to appreciate the controversy, we are reproducing in brief the findings of the Assessing Officer/TPO and the Income Tax Appellate Tribunal ('Tribunal', for short) in the case of Sony Mobile Communication Ltd, i.e. the assessee/appellant in ITA No.16/2014 and the assessee/respondent in ITA No.155/2014 filed by the Revenue pertaining to assessment year 2008-09; Reebok India Company Ltd., i.e. the assessee/appellant in ITA No.109/2014 and the assessee/respondent in ITA No.213/2014 filed by the Revenue relating to assessing year 2008-09; and, Canon India Pvt. Ltd., i.e. the appellant in ITA No.512/2013 and respondent in ITA No.12/2014 filed by the Revenue relating to assessment year 2006-07. The said three assessees have been selected because in the case of Sony Mobile Communication Pvt. Ltd., Transactional Net Margin Method ('TNM Method', for short) has been followed and in the case of Reebok India Company Ltd., TNM Method has been followed in respect of goods' sourcing and exports from India; Comparable Uncontrolled Price Method ('CUP Method', for short) has been followed in respect of royalty paid by the Indian AE to the foreign AE and in respect of which separate substantial question of law has been framed and Resale Price Method ('RP Method', for short) has been followed for import of apparels and footwear for re-sale. In the case of Canon India Pvt. Ltd., RP Method was adopted by the assessee for import of finished goods for resale. In the said case, the order passed by TPO is detailed and is a lucid exposition of the stand of the Revenue.

SONY MOBILE COMMUNICATION PVT.LTD.

ITA No.16/2014 (By the Assessee) and ITA No.155/2014 (By the Revenue) Assessment year 2008-09

5. The assessed was a subsidiary of a Sweden based entity, 'Sony Ericss Mobile Communications AB', a 50:50 joint venture of Sony Corporation (Japan) and Telefonaktiebolaget LM Ericsson (Sweden). The assessed was engaged in importing/buying and selling, and distribution, promotion and marketing of mobile handsets under the brand name 'Sony Ericsson', and providing post sale support/warranty services in India. The assessee in the transfer pricing report accepted that the group companies, i.e. the AEs, owned significant and valuable intellectual property rights in commercial or marketing intangibles in the form of brand-name, trademark, logos, etc. but the assessed did not own any significant or valuable non-routine intangibles. The assessed was primarily an importer performing distribution and marketing functions by reselling the imported handsets with its primary functions being sales, budgeting, inventory scheduling, marketing including advertisements and sale promotions, creating distribution channels, and servicing warranty claims.

6. As per the transfer pricing report, the assessed had declared net profit margin of 2.5% which was better than the average or mean of 18 comparables (wrongly mentioned as 19). The assessee had applied the TNM Method for computing the arm's length price and the Profit Level Indicator ('PLI', for short) adopted was total turnover, in proportion to the net profit rate. While computing the net profit, the assessee had included credit notes worth Rs.73,83,70,409/- received from the overseas/foreign AEs in December, 2007 and March, 2008.

7. The TPO held that Rs.73,83,70,409/- represented excess price charged by the AE and were issued to achieve the arm's length return in accordance with the business model of the assessee. He observed that the total AMP expenditure of Rs.115,72,15,159/- on gross sales of Rs.1,638,68,08,123/- gave AMP to sales ratio of 7.06%. Business promotion and selling expenses of Rs.49,66,58,381/-

were included and added to arrive at the figure of AMP expenses Rs.115,72,15,159/-. Out of the 18 comparables suggested by the assessee, the TPO accepted 12 and rejected 6 for they were involved in brand promotion activities being the owners of the brand-name or the intangibles. The mean AMP to sales ratio of the 12 comparables was 3.35%. This figure of 3.35% was treated as the 'bright line' and accordingly the AMP expenditure, exceeding the said ratio was treated as non-routine or abnormal. Thus, Rs.60,82,57,087/- was treated as abnormal or excessive AMP expenditure. To this, the TPO added a mark-up of 15%. Rs.73,83,70,409/- received as credit notes was not set off against the AMP expenses. The TPO made the following computation:-

Computation of TP adjustment	In Rs.
Value of Gross Sales	16,386,808,123
AMP/Sales of Comparables	3.35%
Amount that represents bright line	548,958,072
Expenditure on AMP by assessee	1,157,215,159
Expenditure in excess of bright line	608,257,087
Mark-up at 15%	91,238,563
Reimbursement that assessee should have received	699,495,650
Reimbursement actually received	NIL
Adjustment to assessee's income	699,495,650

8. The Dispute Resolution Panel ('DRP', for short) substantially rejected the assessee's objections but reduced the mark up from 15% to 12.5% observing it to be the reasonable mark-up.

9. The Tribunal in the impugned order dated 30th August, 2013, observed that the Function, Asset and Risk analysis ('FAR analysis', for short) of the assessee and the comparables was not disputed by the TPO and hence accepted. The 'bright line test' ratio of 3.35% as applied on recalculation would be 4.02%, considering the partial relief granted by the DRP in excluding 2 comparables. Thus, the abnormal or non-routine AMP expenditure would be to the extent of 3.04% (7.06 – 4.02). Further, quantum of the AMP expenses computed by the TPO/ Revenue required re-computation in terms of the decision dated 23rd

January, 2013 of the Special Bench of the Tribunal, in ***L.G. Electronics Ind Pvt. Ltd. versus Assistant Commissioner of Income Tax***, reported as (2013) 152 TTJ 273 (Del). Further, the mark up of 12.5% as sustained by the DRP, was not based upon any comparable. Lastly, failure to account for Rs.73,83,70,409/- in the form of credit notes was not elucidated and explained by the Revenue. Accordingly, an order of remand was passed.

REEBOK INDIA CO. LTD.

ITA No.109/2014 (by the assessee) and ITA No.213/2014 (by the Revenue) Assessment Year 2008-09

10. The assessee belongs to 'Adidas Group', stated to be a global leader in sportswear goods' industry with broad portfolio of products. The group has approximately 100 subsidiaries and office of the parent company is located in Germany with key corporate units in the United States of America.

11. The assessed Reebok India Co. Ltd. was incorporated in 1995 as a joint venture between Reebok Mauritius and Focus Energy Ltd., India. As per the details furnished by the assessee, they had entered into the following international transactions:

"

S. No.	**Nature of Transaction**	**Method used by assessee**	**Amount**
1.	Import of apparels and footwear for resale	RPM	34,75,63,922
2.	Royalty	CUP	15,28,77,527
3.	Identification of factories in India for sourcing/exporting the goods	TNMM	73,87,878

"

The aforesaid table also gives details of method adopted by the assessee. The assessee had received reimbursement of advertisement and other expenses to the tune of Rs.44,67,273/- from the AE.

12. In the appeals, we are concerned with the international transaction at S No.1, i.e. import of apparels and footwear for resale in India. Transaction No.2 also arises for consideration, but has been examined separately. The assessee had adopted RP Method for arm's length determination of transaction No.1. The gross margin earned and declared by the assessed from controlled transactions was 42.95%, compared to 42.52% earned from internal comparables, i.e. transactions of the assessed with unrelated parties. Thus, it was claimed that the price of uncontrolled transaction was at arm's length.

13. The TPO quoted and relied on the clauses of the agreement dated 1st March, 1995, with Reebok International Ltd., England, to highlight that the functions of the Indian AE were to promote and develop the market for selling and distributing the Reebok branded products in India and to support and cooperate in execution of global marketing plans and strategies. Referring *the OECD's report on transfer pricing guidelines from Multi-national Enterprises and Tax Administrations*, paragraphs 6.4 and 6.36 to 6.39, the TPO observed that when a distributor bears the cost of "extraordinary" marketing activities, he should be compensated with return on the intangible created because of such expenditure. Distinction between short-term and long-term relationship was highlighted. He referred to Australian Tax Code as well as the U.S. IRS Regulations. He held that in the OECD Guidelines and as per international tax practices and jurisprudence, the 'bright line test' was an acknowledged and accepted tool to determine and ascertain routine and non-routine AMP expenses. He made reference to the cases of DHL and GlaxoSmithKline. Relying on the decision of the Delhi High Court in ***Maruti Suzuki India Ltd. versus Addl. CIT/TPO*** [2010] 328 ITR 210 (Del), he held that the assessed was engaged in brand promotion by incurring AMP expenses. He made reference to the following table:

F.Ys.	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Sales (WSP)	69.6	89.4	118	169.4	252.5	366.2	451.23
Sales (MRP)	133.9	172	226.9	325.8	485.6	704.3	867.76
AMP (Gross)	2.6	4.2	5.3	8.3	19.3	27.2	40.62
AMP (Reimbursement)	0.3	0.3	0.3	0.3	3.1	5.1	0.11
AMP (net)	2.4	3.9	5.0	8.0	16.2	22.1	40.50
AMP (Net)/Sales (MRP)	1.78%	2.29%	2.21%	2.44%	3.34%	3.14%	4.67%
AMP (Gross)/ Sales (WSP)	3.73%	4.69%	4.49%	4.89%	7.64%	7.43%	9.00%
% Reimbursement of AMP/ AMP Gross	11.54%	7.14%	5.66%	3.6%	16.06%	18.75%	0.27%

14. TPO observed that AMP expenditure had increased significantly as percentage of sale. Further, the assessee had offered discounts in the form of growth incentive scheme and business volume discount scheme. These expenses were not linked with advertisement functions, but they had worked to enhance the brand value by popularizing the use of the product through discount and attractive offers, creating familiarity and market for the products. Thus, the said expenditure should be added to AMP expenses. Accordingly, Rs.16,61,12,065/- on account of selling and distribution was added to the advertisement and publicity expenditure of Rs.39,01,24,915/- to reach a figure of Rs.55,62,36,980/-, which gave the ratio of AMP to sales of 12.33%.

15. On the question of 'bright line' comparables, the TPO rejected companies like Colgate India Ltd., Dabur India Ltd., GlaxoSmithKline Consumer Healthcare Ltd., Hindustan Unilever Ltd., Marico Ltd., Trent Ltd., and Emami Ltd., with the ratio of AMP to sales of Rs.12.52%, observing that these companies were engaged in promotion of their own name and the AMP expenses incurred by them were non-routine. Another list of five comparables was rejected on different grounds. This list included Khadim India Ltd. and Liberty Retail Revolutions Ltd. engaged in similar business of footwear.

16. The TPO adopted the following comparables for bright line limit:

S.No.	Name of the Company	AMP Expenses/sales (%)
1.	Bhartiya Global Marketing Ltd.	2.15
2.	Globus Stores Pvt. Ltd.	4.66
3.	Pokarna Fashions Ltd.	1.49
4.	Snowhite Apparels Ltd.	1.72
	Mean	2.51

17. On this base/ratio of 2.51% of AMP to sales, excess or disproportionate AMP expenses in the case of the assessed were calculated as under:

“Value of Gross Sales	451,23,49,038/-
AMP/Sales of comparables	2.51%
Amount that represent bright line	11,32,59,961/-
Expenditure on AMP by assessee	55,62,36,980/-
Expenditure in excess of brightline	44,29,77,019/-”

18. The TPO held that the assessee was reimbursed Rs.11,43,021/- for the aforesaid non-routine AMP activities and was entitled to re-imbursement for the entire expenditure, plus mark-up of 15% which he considered to be reasonable as it took care of the interest costs which the assessee had to bear on the money invested in developing and marketing intangibles. Accordingly, total upward adjustment of Rs.66,11,58,078/- was suggested.

19. The DRP substantially rejected the objections of the assessee except that they reduced the mark up to 12.50%, and consequently reduced the adjustment to Rs.49,72,06,162/-.

20. The Tribunal in the impugned order has referred to the bifurcation of selling and distribution expenditure of Rs.1,66,12,066/- which is as under:

S.No.	**Nature of expenses**	**Amount (Rs.)**
1	Commission on sales	15,852,692
2	Common area Maint. Charges	385,206

3	Discount to customers on cash down payment.	566,030
4	Official meetings.	1,346,832
5	Rate/ margin difference credit notes.	3,368,491
6	Sales scheme credit notes.	45,711,507
7	Sales staff business expense	1,811,849
8	Store brokerage charges	1,646,169
9	Store expenses	2,850,634
10	Store Registration Charges	1,895,050
11	Tax reimbursement credit notes	3,493,251
12	VAT paid on purchases	2,960,787
13	Sample courier charges	11,064,039
14	Gym charges	355,988
15	Sample expenses for manufacture, suppliers and trade shows.	23,396,979
16	Export forwarding and clearing expenses	3,569,537
17	Misc. Expenses	3,960,471
18	Sales incentive expenses	2,869,355
19	Warehouse running and maintenance expenses	28,795,393
20	IITTF trade fair stall expenses	1,810,963
21	Store general Merchandising	8,400,943
	Total	166,12,066

21. Referring to the judgment in ***LG Electronics India Pvt Ltd.*** (supra), the following directions stand passed:

> "11. Accordingly, we remit the issue of AMP expenses to the files of the TPO with the following directions:-
>
> i) Expenditure in connection with the sales as mentioned above cannot b e brought within the ambit of advertisement, marketing and promotions expense for determining the cost / value of the international transactions. However, the TPO shall examine the veracity of description and quantification of the amount of selling expenses and accordingly, allow the assessee's claim.

> ii) After deducting the selling price from the AMP expenses as mentioned above, the TPO shall decide the issue of AMP expenses by applying the proper comparables after hearing the assessee and keeping in view the Special Bench directions in this behalf."

CANON INDIA PVT. LTD.

ITA No.521/2013 (by the assessee) and ITA No.132/2014 (by the Revenue) Assessment Year 2006-07

22. The assessee, Canon India Pvt. Ltd., is a wholly owned subsidiary of Canon Singapore Pte Limited. The assessee had started Indian operations in 1996 and had entered into various international transactions with Canon group of companies. It had entered into agreements pertaining to purchase and re-sale of Canon products like photocopiers, fax machines, printers, scanners and cameras in India. Besides, the assessee was also engaged in software development and related services to Canon group of companies. As per the transfer pricing report, the assessee had entered into the following international transactions:

Table 1

S.N.	Nature of transaction	Method used by Assessee		Value of transaction	
		Method	PLI	Receipt	Paid
1-	Import of finished goods for resale	RPM	GP/ Sales	—	169,75,21,034
2.	Export of Software (Credited to P/L A/c)	TNMM OP/OC	OP/Sales	13,28,40,833	--
3.	Provision of software Service (Credited to Service Income in P/L)	TNMM	OP/OC	5,78,81,229	
4	Reimbursement of professional charges	Not bench-marking			16,27,161
5	Cost allocation in respect of computer management fees.	Not bench-marking		----	12,16,326

6	Receipt of special purpose subsidy	No bench-marking	---	12,10,48,124	—
7	Reimbursement of expenses	At cost	---	55,03,334	5,12,007

23. The TPO in his order observed that the assessee was engaged in brand building development or enhancing marketing intangibles. The precise meaning of the term 'marketing intangibles' was unclear from text or legal perspective but it would include trade-name, trademark, trade-dress and logos, the local market position of companies or its product know-how that surrounds a trademark such as knowledge of distribution channels, customer relationship, trade secrets, etc. Investment in marketing intangibles was derived from amongst others, the company's level of advertisement, marketing and promotion or AMP. Reference was made to OECD guidelines in paragraphs 6.36 to 6.38; and US IRC Section 482 to the following effect:

> "(a)The US distributor was simply given set transfer price and the development of the US market was at risk and economic cost of the US distributor.
>
> (b) The foreign parent indirectly subsidized the development of the US market through a reduced transfer price.
>
> (c) The foreign parent provided the distributor with a rebate of a portion of the distributor's AMP expenditure based on sales volumes. Following the theories in the above Tax Court case, the cheese examples could require a return for the distributor investment in the marketing intangibles either in the form of a service fee arrangement with an appropriate profit margin or more robust operating margins to reflect the return for the developed marketing intangible. For the tax authorities sought to disallow a portion of the AMP expenditure under the notion that it was incurred on behalf of foreign trademark owner."

24. Reference was made to the decisions in DHL Inc. and subsidiaries and GlaxoSmithKline Holding (America's) Inc., and Australian Tax Office Guidelines to hold that the AMP expenses should be separately benchmarked.

25. The TPO held that the assessee had incurred AMP expenses totalling Rs.37,88,97,359/-, or 12.08% of the total sales, whereas subsidy of Rs.12,10,48,124/- was received. Thus, balance expenditure of Rs.25,78,49,235/- was borne by the assessee. The assessee had failed to bench mark international transaction of Rs.12,10,48,124/-. He rejected the argument of the assessee that the subsidy was to lend financial support and this support was akin to discount and reduction of sale price, relying on the written submission of the assessee, bifurcating the subsidy in the following manner:

Computation of subsidy	
Description	**Amount (INR)**
Price support for government tender	43,65,000
Advertisement activities for DV	15,66,296
Channel schemes and consumer promos	22,52,385
Consumer promo awareness building	23,51,211
Product launches and market research report	26,16,549
Retail activities and road show etc.	8,74,420
Photo Asia and channel promotion programme	30,93,044
Dealer channel promotion for digital cameras	31,82,441
Channel schemes and consumer promos	28,15,870
Advertisement and sales promotion support for fax machines	19,84,606
Advertisement and sales promotion for photocopiers	40,07,023
Credit note	83,902
Marketing development	3,76,717
Advertisement and sales promotion support for printers and all in one	50,69,210
Advertisement and sales promotion support for large format	3,87,854
Advertisement and sales promotion for photocopiers	31,40,325
Printers IP 1000 Liquidation support	22,12,320
Advertisement Campaign for EOS Gery	34,29,750
Advertisement and sales promotion support for DSLR	57,16,250
Advertisement and sales promotion, schemes and activities for DSLR	22,86,500
Advertisement and sales promotion, schemes and activities for DSLR	22,86,500
Digital Cameras- Exhibitions, retail banding and support	26,52,340
Digital Cameras- Exhibitions, retail banding and support	21,03,580
Digital cameras - Sponsorships, free gifts and promos	20,57,850
Digital cameras- Exhibitions and promo supports	18,29,200
Digital Cameras — Road shows and promotional activities	23,77,960
Advertisement and sales promotion support for laser beam printer	30,18,180

Advertisement and sales promotion support for canon expo events - Si printer	25,37,421
BJ printer for advertisement and sales promotion	23,18,237
Si printer - retail Partners support	28,33,888
Ill printer - market development support	14,56,455
Projector promotions	4,46,067
Digital cameras — road show POS and promo material	18,01,200
LV X5 DGS&D 20 sets	1,21,581
Against Nikon Exchange programme - advertisements and mailers	6,91,526
Market development support for copiers	89,93,987
Market development support for copiers	98,72,372
market development support for faxes	27,10,972
market development support for faxes	13,57,566
Fabrication and display of neon signs	20,40,011
Advertisement and sales promotion support for scanners	12,86,044
LFP Advertisement and promotion	5,43,149
Major account support for market development and deliverables	9,10,000
Trade-in (buy back) for DC channel sales	14,62,000
Advertisement and promotion -LBP schemes	25,39,980
Advertisement and promotion - LBP support for GIL project through SI Acer	19,59,300
Advertisement and Promotion for DV -To implant promoters in stores for 6 months	2,86,250
Advertisement and promotion for DC -1 GB CF card for promo	7,80,000
Advertisement and promotion for DC POS MERCHANDISING, PHOTOFAIR	19,02,556
Shows and seminar for copiers	18,94,916
Black & white and colour advertisement for copiers	18,53,126
Advertisement and promotion - Expenses BIS-PGA	3,12,236
Total	**12,10,48,124**

(The table is extracted from reply of the assessee dated 20.03.2009)"

26. The Indian assessed was described by TPO, as limited risk distributor whose profit margin during different financial years were as under:

F.Y.	**2001- 02**	**2002- 03**	**2003- 04**	**2004- 05**	**2005-06**
Profit margin of the assessee	-1.33%	-0.75%	4.82%	4.47%	4.10%

But the profit margin of Canon Inc., Japan was substantial higher and was under:

F.Y.	2001- 02	2002- 03	2003- 04	2004- 05	2005-06
profit margin of Canon Inc. Japan (AE) *	9.68%	11.23%	14.01%	15.92%	16.30%

*the profit margins of the Canon as mentioned in the table pertain to year 2001,2002,2003,2004 and 2005 as extracted from Orbis database."

27. He did a comparison between percentage of AMP to gross sales of the Indian AE, i.e. the assessee and the profits margin of Canon Inc., Japan to observe that there was a co-relation between increase in the profit margin of the parent AE and the enhanced AMP of the Indian AE and there was a negative co-relation between the profitability of the Indian AE and the AMP expenditure incurred by Indian AE.

28. The TPO thus recorded that the Indian AE had borne significant costs and risk associated with development of AE's trademark in India. The assessed was entitled to retain associated intangible income. In order to compute the non-routine or excessive AMP, the TPO adopted the following steps or procedure:

> "Step 1: first step is to determine AMP expenditure of the assessee,
>
> Step 2: selection of comparables for determining bright line limit, out of the list of finally selected comparable by the assessee in its transfer pricing report for benchmarking of International transaction of purchase of Canon product from AE using RPM. In the selection x. process, each comparable was examined to ascertain whether these comparables are routine distributor or engaged in brand promotion and development of marketing intangible for the related party or itself being owner of brand trademark. After this analysis only those comparable which are engaged in routine distribution business and are not carrying out of non routine activities like trade mark promotion and development of marketing intangible are selected.
>
> Step 3: to determine AMP expenditure of the comparables finally selected for benchmarking of international transaction of subsidy.

> Step 4: the ratios of AMP. expenditure to the sales of uncontrolled comparables (routine distributors) were taken as comparable uncontrolled price which were compared with the ratio of AMP expenditure to the sales in the case of the assessee to determine bright line limit as discussed in paragraph 7.5 and 7.6 of this order.
>
> Step 5: the AMP expenditure of the assessee which was in excess of bright line limit determined on the basis of comparable uncontrolled AMP prices was held as arm's length price of-the subsidy."

29. Accordingly, the TPO observed that the total AMP expenditure of Rs.37,88,97,359/-, inclusive of discount and volume rebate of Rs.16,07,59,162/- gave a percentage of AMP expenditure to total turnover, of 12.08%. For the purpose of comparables, TPO rejected the comparables adopted by the assessee to benchmark the international transaction for purpose of non-routine AMP expenses, recording:-

Company Name	Gross advertisement sales promotion and related expenditure	Trade discount	Operating income from third parties	Percentage of Adv. Exp to sales	Comments
ACI Infocom Limited	NA	NA	357,682,028	NA	Not separately disclosed in financials
Compuage Infocom Limited	NA	NA	2,150,581,000	NA	Not separately disclosed in financials
HCL Infosystem Limited	NA	NA	24,362,000,000	NA	Repair schedule 17. advertisement publicity and entertainment net of reimbursements
Kilbum Office automation Limited	6,099,997	NA	292,627,187	2.08	Trade discount not shown separately
Savex computers Limited	96,628,689	NA	2,879,632,210	3.36	Trade discount not shown separately
Spice Limited	61,046,000	NA	1,195,018,000	5.11	Trade discount not shown separately
Spice systems Limited	49,146	NA	19,187,953	0.26	Trade discount not shown separately
SPS international Limited	951,969	NA	110,577,806	0.86	Trade discount not shown separately
Universal print systems limited	759,065	NA	124,953,087	0.61	Trade discount not shown separately
Xerox India limited	629,983,000	NA	5,342,437,000	11.79 .	Trade discount not . .shown _separately

Arithmetic mean (for comparables)				3.44	

30. He observed that profile of Spice Systems Ltd. and Xerox India Ltd. should not be included in the comparables for that they were engaged in non-routine functions like development of marketing intangibles. The remaining 5, engaged in routine functions, should be selected for applying the 'bright line' limit of routine AMP expenses. The arithmetical mean of percentage of AMP expenses to sales, was computed at 1.434% as per the following table.

Company Name	Percentage of Adv. Exp to sales
Kilburn Office Automation Limited	2.08
Savex computers Limited	3.36
Spice systems Limited	0.26
SPS international Limited	0.86
Universal print systems limited	0.61
Arithmetic mean (for comparables)	1.434%

31. The following table from TPO's order determines the arm's length price:

"Total Revenue of the assessee	Rs. 313,43,55,280
Arm's length % of AMP Expenditure	1.434%
Arm's length AMP Expenditure	Rs.4,49,46,654
Expenditure incurred by the assessee on AMP	Rs.37,88,97,359
Expenditure incurred for developing the intangibles	
Rs. 37,88,97,359- Rs. 4,49,46,654	Rs. 33,39,50,705
Arm's length value of the Subsidy	Rs. 33,39,50,705
Amount of Subsidy received by the Assessee	Rs. 12,10,48,124
Difference	Rs. 21,29,02,581

% of Difference with Value at which international transaction has taken place 175.88%"

32. Arm's length price for non-routine AMP expenses was computed at Rs.21,29,02,581/-, recording the arm's length difference of 175.88%.

33. The DRP upheld the suggested transfer pricing adjustment.

34. The Tribunal in the impugned order has observed that following the majority judgment in ***L.G. Electronics India Pvt Ltd.*** (supra), the legal grounds should be decided against the assessee. On the question of nature and scope of AMP expenditure, as elucidated by the majority judgment in ***L.G. Electronics India Pvt Ltd.*** (supra), it was held that the sale related expenses, i.e. trade discount, volume rebate, cash discount, commission etc. should be excluded. To this extent, the appeal filed by the assessee was allowed for statistical purpose, directing that there was no justification for setting aside the expenses for verification again to the Assessing Officer/TPO. The details of the subsidy, trade and volume discount, cash discount and commissions as quantified were:-

“

Particulars	**AY 2006-07**	**AY 2007-08**	**AY 2008-09**
	Amount (INR)	**Amount (INR)**	**Amount (INR)**
A AMP including trade discount and volume rebates and before reducing subsidy	**378,897,359** (para 7.26 page 200 of PB 1)	**581,062,073** (para 7.29 page 388 of PB 2)	**958,063,110** (para 4.2 page 46 of PB 1)
B Less: Subsidy	12,10,48,124	27,10,87,594	50,16,13,022
C Less: Trade Discount & volume rebates	14,00,83,068	15,59,68,614	19,65,29,801
D Less: Cash Discount / Commission	2,06,76,094	-	51,49,784

E Total AMP expendi-ture to be consider-ed for purpose of comparison in light of Special Bench Order	9,70,90,073	15,40,05,865	25,47,70,503

"

35. On reducing the aforesaid figure from the AMP expenses of Rs.37,88,97,359/-, the total AMP expenses were computed as Rs.9,70,90,073/-.

36. Subject to the aforesaid, an order of remand was passed to apply and determine the arm's length price of the AMP expenses by applying the ratio of the majority judgment in ***L.G. Electronics India Pvt Ltd.*** (supra).

B. ***L.G. Electronics India Pvt. Ltd. versus CIT***

37. In the impugned orders, the Tribunal has primarily relied upon and followed the majority judgment of the Special Bench of the Tribunal in ***L.G. Electronics India Pvt Ltd*** (supra). Learned counsels for the parties have extensively referred to both majority and minority judgment in their erudite and pensive arguments. The decision of the Special Bench in ***L.G. Electronics India Pvt Ltd.*** (supra) has not yet been made a subject matter of challenge before the High Court by both the assessee therein and the Revenue, for the said appeal is still pending before the Tribunal and has not yet been finally decided. However, as the issue is a recurring one, arising in significant number of cases with substantial tax effect and even the Revenue is aggrieved by certain portions of the said decision, it would not be appropriate and proper to adjourn these

appeals to await filing of appeal/cross-appeal in the case of ***L.G. Electroni***

India Pvt Ltd. (supra). Both sides have pressed for immediate hearing.

38. The majority judgment in ***L.G. Electronics India Pvt Ltd.*** (supra) had reached the following findings:-

(i) In terms of the Sub-Section 2B to Section 92CA, a TPO could have examined and applied transfer pricing provisions to a transaction, which comes to his notice, in respect of which the assessee has not furnished a report under Section 92E of the Act. Amendment by the Finance Act, 2012 incorporating Sub-Section 2B to Section 92CA was retrospective and applicable with effect from 1st June, 2002. Thus, the TPO could have examined the unreported international transaction relating to the AMP expenses.

(ii) AMP was an international transaction, given the contours and ambit of the term 'transaction' and 'international transaction' as defined in the Act.

(iii) The said character as an international transaction cannot be denied or negated because AMP expenditure was incurred in India and was paid by the assessed to independent parties in India.

(iv) The contention that there was no express agreement *apropos* brand building for incurring AMP expenses was rejected, holding that such agreement or understanding could be inferred and could also be oral. Reference was made to the definition of the terms 'transaction' and 'international transaction' including the retrospective insertions made by the Finance Act, 2012, to explain the two terms.

(v) The TPO was entitled to re-categorize any transaction; (i) where t economic substance of the transaction differs from its form; (ii) where the form and substance of the transaction are the same, but the arrangements made in relation to the transaction, when viewed in their totality, differ from those which would have been adopted by an independent enterprise behaving in a commercially rational manner. Relying upon the decision of the Delhi High Court in ***CIT versus EKL Appliances Ltd.*** [2012] 345 ITR 241 (Del), which refers to the OECD Commentary carving out the two exceptions, it has been held that the second exception was applicable. Thus, the TPO could have re-categorized the international transaction as declared to determine arm's length price of the unravelled and deciphered international transaction as per the mandate of Section 92CA(2B) of the Act.

(vi) In order to determine and decide whether an assessed had an AMP international transaction with an AE, the TPO could rely upon the 'bright line test', both to determine and re-categorize the international transaction, and to compute the contractual value or the price of the said transaction. Application of the 'bright line test' was not contrary to the Act, i.e. the Income Tax Act, 1961.

(vii) Application of the 'bright line test' was only to segregate the AMP expenses incurred by an assessee for their own business and compute the value or cost of the AMP expenses incurred by the assessee for promoting brand value of the AE, resident abroad.

(viii) 'Bright line test' does not require statutory endorsement.

(ix) On application of the 'bright line test', if it is ascertained and deduced that the assessed had incurred non-routine AMP expenses beyond what a similarly situated independent, non-brand owner Indian distributor wou have incurred under the circumstances, this quantum of difference or excessive expenditure should be treated as an independent international transaction of brand building for the foreign AE, the owner of the said trademark or brand.

(x) The Tribunal did not approve of the benchmarks or the comparables adopted by the TPO to apply the 'bright line test'. The said test should be applied by comparative analysis of comparable uncontrolled cases which should be really comparable, i.e. the comparable must deal with the same genus of products; have comparable market share; and the assets employed; the functions performed and the risks assumed should be similar. Paragraph 17.2 reads:

> "17.2. We find that the first step in making comparability analysis, is to find out some comparable uncontrolled cases. It goes without saying that a comparison can be made with the cases which are really comparable. A case is said to be comparable when it is from the same genus of products and also other relevant factors, such as, type of products, market share, assets employed, functions performed and risks assumed, are also similar. Once proper comparable cases are chosen, then the next step is to neutralize the effect of the differences in relevant facts of the case to be compared and the assessee's case, by making suitable plus or minus adjustments."

(xi) The Tribunal enumerated 14 criteria/parameters for selection of comparables for applying the 'bright line test' and determination of the cost/value of the international transaction of brand/logo promotion by incurring AMP expenses by an Indian AE, for its foreign AE. The 14 point criteria stand recorded in paragraph 17.4, which has been quoted below:-

> "**17.4** In our considered opinion, following are some of the relevant questions, whose answers have considerable bearing on the question of determination of the cost/value of the international transaction of brand/logo promotion through

advertising, marketing and promotion expenses incurred by the Indian associated enterprise for its foreign entity :

1. Whether, the Indian associated enterprise is simply a distributor or is a holding a manufacturing licence from its foreign associated enterprise?

2. Where the Indian associated enterprise is not a full-fledged manufacturer, is it selling the goods purchased from the foreign associated enterprise as such or is it making some value addition to the goods purchased from its foreign associated enterprise before selling it to customers?

3. Whether, the goods sold by the Indian associated enterprise bear the same brand name or logo which is that of its foreign associated enterprise?

4. Whether, the goods sold bear logo only of foreign associated enterprise or a logo which is only of the Indian associated enterprise or is it a joint logo of both the Indian entity and its foreign counterpart?

5. Whether, the Indian associated enterprise, a manufacturer, is paying any royalty or any similar amount by whatever name called to its foreign associated enterprise as a consideration for the use of the brand/logo of its foreign associated enterprise?

6. Whether, the payment made as royalty to the foreign associated enterprise is comparable with what other domestic entities pay to independent foreign parties in a similar situation?

7. Where the Indian associated enterprise has got a manufacturing licence from the foreign associated enterprise, is it also using any technology or technical input or technical know-how acquired from its foreign associated enterprise for the purposes of manufacturing such goods?

8. Where the Indian associated enterprise is using technical know-how received from the foreign associated enterprise and is paying any amount to the foreign associated enterprise, whether the payment is only towards fees for technical services or includes royalty part for the use of brand name or brand logo also?

9. Whether the foreign associated enterprise is compensating the Indian entity for the promotion of its brand in any form, such as subsidy on the goods sold to the Indian associated enterprise?

10. Where such subsidy is allowed by the foreign associated enterprise, whether the amount of subsidy is commensurate with the expenses incurred by the Indian entity on the promotion of brand for the foreign associated enterprise?

11. Whether, the foreign associated enterprise has its presence in India only in one field or different fields ? Where it is involved in different fields, then is

> there only one Indian entity looking after all the fields or there are different Indian associated enterprises for different fields ? If there are different entities in India, then what is the pattern of advertising, marketing and promotion expenses in the other Indian entities?
>
> 12. Whether the year under consideration is the entry level of the foreign associated enterprise in India or is it a case of established brand in India?
>
> 13. Whether any new products are launched in India during the relevant period or is it continuation of the business with the existing range of products?
>
> 14. How the brand will be dealt with after the termination of agreement between associated enterprises?"

(xii) The contention of the assessee that comparable cases would be those using foreign brand was expressly rejected in paragraph 17.6. The Tribunal rejected the contention of the assessee that they were economic owners of the brand and in commercial sense their right in the brand name / trademark should be accepted. Concept of economic ownership of a brand, albeit relevant in commercial sense, was not recognized for the purposes of the Act. Retailers or dealers of electronic products etc. who sell branded products do not become economic owners of the branded products sold by them. Paragraph 17.6 reads:

> "17.6. In principle, we accept the contention of the ld. AR about the necessity of choosing properly comparable cases in the first instance before starting the exercise of making comparison of the AMP expenses incurred by them for finding out the amount spent by the assessee for its own business purpose. However the way in which such comparable cases should be chosen, as advocated by the ld. AR, is not acceptable. He submitted that only such comparable cases should be chosen as are using the foreign brand. We find that choosing cases using the foreign brand ex facie cannot be accepted. It is but natural that the AMP expenses of such cases will also include contribution towards brand building of their respective foreign AEs. In such a situation the comparison would become meaningless as their total AMP expenses will stand on the same footing as that of the assessee before the exclusion of expenses in relation to brand building for the foreign AE. The correct way to make a meaningful comparison is to choose comparable domestic cases not using any foreign brand. Of course when effect will be

> given to the relevant factors as discussed above, it will correctly reflect the cost/value of international transaction."

(xiii) Contention of the assessee that TNM Method required comparison of overall net profit of the assessee with the comparables, was rejected for the following reasons:

(a) The TNM Method postulated in the Rule 10B(1)(e) of the Income Tax Rules, 1962 ('Rules', for short) stipulates benchmarking of "a" transaction in singular as defined in Rule 10A(d). TNM Method would relate to profit margin of "a" transaction and not net profit of an entity or total sales of the entity. It is a transaction and not an entity based method.

(b) Scrutiny of Chapter X of the Act and language of Section 92(3) mandates and sanctions that TNM Method would be applied only on a transactional level and not at the entity level.

(c) Bunching of international transactions was not permissible and each international transaction has to be separately valued and accordingly arm's length price computed. Each transaction should be taken as an independent transaction, for computing arm's length price.

(d) Profit of an entity would depend upon several factors which contribute in earning of profits. Thus, costs of AMP expenses were independent of cost of raw material/products.

(e) The factum that the assessed had declared an overall higher profit rate in comparison with the comparables was insufficient and sparse. It was certainly not a licence to the assessed to not record the AMP expenses as an international transaction. Benefit, service or facility furnished and provided to the AE resident abroad required compensation at arm's length price.

(xiv) The argument that expenditure incurred on AMP was subsumed a included in the value of the international transaction already disclosed and paid for by the foreign AE, was rejected for there could be no reason or ground for such assumption.

(xv) The argument of the assessed that under the TNM Method, the net profit of the entity includes the effect of transactions subject matter of arm’s length price between the two AEs, was also rejected on the ground that the effect of five methods prescribed under Chapter X was towards one end, i.e. determination of arm’s length price of an international transaction and consequences of each method *qua* the international transaction cannot be at variance. Thus, TNM Method should not be applied at entity level.

(xvi) The contention of the assessed that set off or adjustment of ‘excessive’/‘higher’ net profit declared on international transactions should be allowed, if the AMP expenses were treated as a separate international transaction, was rejected, relying upon Section 92(3) of the Act. Set off or adjustments cannot be allowed in respect of profits and gains of one international transaction against another international transaction.

(xvii) The Assessing Officer/ TPO without specific reference had in substance applied the Cost Plus Method (‘CP Method’, for short) for computing the arm’s length price of the international transaction, i.e. the AMP transaction between the AE resident abroad and the Indian assessed. The CP Method was one of the methods prescribed in Chapter X of the Act.

(xviii) Mark-up is mandated under the CP Method. The mark-up had not be correctly computed with reference to comparables and, therefore, determination of quantum of mark-up required remand.

(xix) The matter also required remand as the TPO, while applying the 'bright line test' and computing the arm's length value or price of the AMP expenses, had not selected appropriate comparables as per the criteria stipulated in paragraph 17.4 of the majority decision.

(xx) Effect of the order passed by the Supreme Court, reported as ***Maruti Suzuki India Ltd. versus Addl. CIT,*** [2011] 335 ITR 121 (SC) on the reasons/ratio expounded by the Delhi High Court in ***Maruti Suzuki India Ltd.*** (supra), was analysed, to hold that the decision of the High Court was not entirely overruled and the *ratio decidendi* of the Delhi High Court judgment on the question of incurring of the AMP expenditure by the Indian AE, whether it benefits the foreign AE, requirement to compensate the Indian AEs and other legal principles enrolled, were binding. What had been set aside by the Supreme Court were the observations on merits relating to facts, and not law. The legal principles enunciated by the High Court in ***Maruti Suzuki*** (supra) were not expressly or impliedly overruled.

(xxi) AMP expenses would not include direct selling costs like trade or volume discounts, incentives etc. Direct marketing and sale related expenses or discounts/concessions would not form part of the AMP expenses.

(xxii) Section 37(1) of the Act and the arm's length proceedings under Chapter X of the Act, operate independently. The AMP expenses, allowable as expenditure under Section 37(1) of the Act, would not affect determination of the arm's length price of an international transaction or income of the Indian assessee who has to pay tax in India. According the TPO was entitled to make adjustment and compute the arm's length price, notwithstanding the legal position that AMP expenses were deductible under Section 37(1) of the Act. Determination and, if required, adjustment of the arm's length price is the mandate under Chapter X of the Act.

39. We are not at this stage referring to the minority decision, though we will be referring to certain portions of the said decision when we take up and answer the issues on merits.

40. At the outset, we would like to begin our reasoning and decision with reference to findings recorded by the majority decision in the ***L.G. Electronics India Pvt Ltd.*** (supra) with which we concur and hold are as per the mandate of the law and the Act.

C. Findings on which we concur with the Tribunal

Section 92CA of the Act

41. Our decision in this and ensuing paragraphs would decide substantial question No.1. For our decision, we would like to reproduce Section 92CA Clauses (1), (2), (2A), (2B) and (2C) of the Act which read:

> "92CA. Reference to Transfer Pricing Officer.—(1) Where any person, being the assessee, has entered into an # international transaction or specified domestic transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm's length price in relation to the said #international transaction or specified domestic transaction under section 92C to the Transfer Pricing Officer.
>
> (2) Where a reference is made under sub-section (1), the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein,

> any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to the #international transaction or specified domestic transaction referred to in sub-section (1).
>
> ***(2A) Where any other #international transaction or specified domestic transaction other than an #international transaction or specified domestic transaction referred under sub-section (1), comes to the notice of the Transfer Pricing Officer during the course of the proceedings before him, the provisions of this Chapter shall apply as if such other #international transaction or specified domestic transaction is an #international transaction or specified domestic transaction referred to him under sub-section (1).
>
> ##(2B) Where in respect of an international transaction, the assessee has not furnished the report under section 92E and such transaction comes to the notice of the Transfer Pricing Officer during the course of the proceeding before him, the provisions of this Chapter shall apply as if such transaction is an international transaction referred to him under sub-section (1).
>
> ###(2C) Nothing contained in sub-section (2B) shall empower the Assessing Officer either to assess or reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year, proceedings for which have been completed before the 1st day of July, 2012.
>
> *Inserted by the Finance Act, 2002, w.e.f. 1-6-2002.
> *** Inserted by the Finance Act 2011, w.e.f. 1-6-2011.
> # Substituted by the Finance Act 2012, w.e.f. 1-4-2013.
> ## Inserted by the Finance Act 2012, w.r.e.f. 1-6-2002.
> ### Inserted by the Finance Act 2012, w.e.f. 1-7-2012.”

42. Section 92CA(1) deals with reference to a TPO by an Assessing Officer, for computation of arm’s length price in relation to an international transaction or a specified domestic transaction. It requires and mandates prior approval of the Commissioner. It is undisputed that the Assessing Officer had taken approval of the Commissioner under sub-section (1) to Section 92CA of the Act. The controversy raised is that the Assessing Officer had not specifically referred and no previous approval of the Commissioner was sought or granted for reference of an international transaction relating to the AMP expenses. Thus, the

valuation of the contract price and computation of the arm's length pri , consequent assessments etc. are without jurisdiction and authority of law.

43. This argument on behalf of the assessees would have been weighty and perhaps justified, if the Legislature by the Finance Act, 2012 had not inserted sub-section (2B). The said Sub-Section is squarely applicable and negates the challenge. In these appeals under Section 260A of the Act, we are not concerned with the constitutional validity of the aforesaid retrospective amendment and are only required to interpret the said provision and apply the retrospective provision if it is applicable. Under sub-section (2B) to Section 92CA, a TPO to whom reference has been made under sub-section (1), is entitled to apply the provisions of the Chapter in respect of an international transaction for which the assessee has not furnished a report under Section 92E of the Act. Thus, where an assessee has failed or not furnished a report in respect of an international transaction, a specific reference for the said transaction under sub-section (1) is not required. It is sufficient, if arm's length pricing issue of any international transaction has been referred to the TPO.

44. On careful analysis of sub-section (2B) to Section 92CA of the Act, the following position emerges:

(a) There should be reference under sub-section (1) to Section 92CA by an Assessing Officer to the TPO in respect of an international transaction.

(b) The reference should be with prior approval of the Commissioner.

(c) Satisfaction of conditions (a) & (b) gives jurisdiction to the TPO.

(d) If during the course of the proceedings, a TPO comes to a conclusion that there was an international transaction for which the said assessed has not furnished a report under Section 92E, the TPO can go into the question of arm's length price and apply the provisions of Chapter X. No speci reference in respect of such hidden/unknown international transaction is required under sub-section (1) to Section 92CA of the Act.

45. The conditions and requirements referred to above are fairly stringent. The TPO has to record a finding on satisfaction of the said conditions to evaluate transfer price of an undeclared and unreported international transaction. The TPO must justify and establish that there was an international transaction. Satisfaction of the conditions can be also inferred from the findings recorded by the TPO. Only when these conditions are satisfied, the TPO would exercise his jurisdiction. Whether or not the said conditions are satisfied in a given case, would first depend upon the factual matrix and also possibly on the appropriate and applicable legal principles. Wrong assumption of jurisdiction by recording an erroneous finding, deciding whether there was a hidden or unknown international transaction or whether a report in respect of the said international transaction under Section 92E was not furnished, are matters that can be argued and adjudicated in appeal.

46. After insertion of sub-section (2B) to Section 92CA of the Act, w.e.f. 1st June, 2002, we have to give full effect to the said provision and not negate or curtail the retrospective effect. A retrospective amendment has a deeming effect and also consequences. The said effect cannot be unwritten or erased. The argument of the assessee that sub-section (2B) to Section 92CA was enacted to protect the additions made by treating the AMP expenses as a separate international transaction, may or may not be correct. But once the legislative language is clear and express, we are only required to give effect to the said retrospective amendment in an appeal under Section 260A of the Act.

47. The majority decision of the Tribunal in ***L.G. Electronics India Pvt L*** (supra) has rightly drawn a distinction between sub-section (2B) and sub-section (2A) to Section 92CA of the Act. Sub-section (2A) was inserted in 2011, i.e. nearly one year before insertion of Section (2B) by the Finance Act, 2012. Sub-section (2A) has not been given retrospective effect and it applies only w.e.f. 1st June, 2011. Sub-section (2A) applies to any international transaction or specified domestic transaction of which reference has not been made to the TPO under sub-section (1). With effect from 1st June, 2011, the TPO can go into arm's length pricing of an international transaction or a specified domestic transaction not referred to him. The distinction between sub-section (2A) and (2B) being that the first clause relates to a declared international transaction, i.e. in respect of which a report under Section 92E has been furnished, whereas sub-section (2B) refers to international transactions in respect of which report under Section 92E is not furnished.

48. Decision in the case of ***CIT versus Max India Ltd.,*** [2007] 295 ITR 282 (SC) is not applicable as it examines the power of the Commissioner under Section 263 of the Act. The said power it was held, in the context of Section 80HHC of the Act, was not rightly exercised at the time when it was exercised, because the order passed by the Assessing Officer on the said aspect was not erroneous or wrong. Revisionary power under Section 263 of the Act can only be exercised when the order passed by the Assessing Officer is erroneous and prejudicial to the interest of the Revenue; the two conditions being cumulative. In this context, it was observed that the subsequent amendment to Section 80HHC in the Act, after the order passed by the Commissioner under Section 263 of the Act, would not determine whether the order passed by the Assessing Officer was erroneous or not. The Commissioner had to record a finding on the date when he passed the order that the order passed by the Assessing Officer was

erroneous. The said pre-requisite was missing, on the date when the order un Section 263 of the Act was passed.

49. There is an additional reason why the assessee's contentions must fail. In the present case, the claim of the assessee is that they had disclosed the international transaction in their report under Section 92E which included AMP expenses incurred by them. This aspect relates to merits, i.e. whether or not there was one composite, bundled or a packaged international transaction, but once for the said transaction a report in Form 92E was submitted, separate reference/approval was not required. Reference of the bundled transaction under sub-section (1) to Section 92CA is sufficient. Section 92CA has to be interpreted pragmatically. Therefore, once reference of a composite/bundled or packaged international transaction is made, it will be difficult for the assessee to contest applicability of sub-section (1) in cases of segregation or when the TPO invokes sub-section (2B) to Section 92CA of the Act. This flaw as it existed stands corrected with insertion of Sub-Section (2B) to Section 92CA with retrospective effect. It clarifies and 'cures' the deficiency and shortcoming of the earlier provision. In view of insertion of sub section (2B) to Section 92CA of the Act, the decision of the Delhi High Court in the case of ***Commissioner of Income Tax versus Amadeus India Pvt. Ltd.*** [2013] 351 ITR 92 (Del) and of the Gujarat High Court in ***Veer Gems versus Assistant Commissioner of Income Tax*** [2013] 351 ITR 35 (Guj) would no longer be applicable as the ratio of the said decisions reflects the position of the statute before enactment of Sub-Section (2B) with retrospective effect.

50. With the aforesaid observations, we decide the first substantial question of law in abstract without reference to the facts as a legal proposition, in favour of the Revenue and against the assessee.

Transaction and International Transaction; Difference between Section 37(1) and Chapter X of the Act

51. The term 'international transaction' has been defined in Section 92B. The section also had retrospective amendment which was inserted by the Finance Act, 2012 w.r.e.f. 1st April, 2002. Section 92B(1) reads as under:

> "**Meaning of international transaction.**
> 92B — (1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises."

52. The contention that AMP expenses are not international transactions has to be rejected. There seems to be an incongruity in the submission of the assessee on the said aspect for the simple reason that in most cases the assessed have submitted that the international transactions between them and the AE, resident abroad included the cost/value of the AMP expenses, which the assessee had incurred in India. In other words, when the assessed raise the aforesaid argument, they accept that the declared price of the international transaction included the said element or function of AMP expenses, for which they stand duly compensated in their margins or the arm's length price as computed.

53. We also fail to understand the contention or argument that there is no international transaction, for the AMP expenses were incurred by the assessed in India. The question is not whether the assessed had incurred the AMP

expenses in India. This is an undisputed position. The arm's leng determination pertains to adequate compensation to the Indian AE for incurring and performing the functions by the domestic AE. The dispute pertains to adequacy of compensation for incurring and performing marketing and 'non-routine' AMP expenses in India by the AE. The expenses incurred or the quantum of expenditure paid by the Indian assessee to third parties in India, for incurring the AMP expenses is not in dispute or under challenge. This is not a subject matter of arm's length pricing or determination.

54. The fact that this expenditure was incurred and has to be allowed as deduction under Section 37(1) of the Act has not been challenged by the Revenue. Revenue in their written submission accepts and has rightly stated that the test of allowability of expenditure under Section 37(1) is whether the said expenditure is incurred wholly or exclusively for the business consideration. So long as the expenditure is for business consideration, the Assessing Officer cannot question the quantum or the wisdom of the assessee in incurring the expense. Issue of arm's length price, *per se* does not arise, when deduction under Section 37(1) is claimed. Expenditure and decision of the assessee, whether or not to incur the said expenditure; the quantum thereof, cannot be a subject matter of challenge or disallowance by the Assessing Officer, once it is accepted that the expenditure was wholly, i.e. the quantum of expenditure incurred was fully, and exclusively for business purpose. In ***Sassoon J. Davit & Co. Pvt. Ltd. versus CIT*** [1979] 118 ITR 261 (SC), it has been held that an assessee can claim deduction for expenditure incurred for business purposes and no one else has authority to decide whether or not the assessee should have incurred the said expenditure. The expenditure cannot be disallowed wholly or partly because it would incidentally benefit a third person once the requirements of Section 37(1) were satisfied. Reference can be also

made to the decision of Delhi High Court in ***CIT versus Nestle India Limit*** [2011] 337 ITR 103 (Del), holding that the question of reasonableness or measure of expenses to be allowed cannot be a subject matter of adjustment or disallowance under Section 37(1) of the Act.

55. Section 40A(2) clause (b) is a provision for computing arm's length price in case of two related parties as defined and applies even when the conditions stipulated in Section 37(1) of the Act are satisfied. The said provision relates to reasonability of the quantum. Similarly, Chapter X of the Act relates to arm's length pricing adjustment. Chapter X is not concerned with disallowance of expenditure but relates to determination of arm's length price/cost of an international transaction between the two AEs. It relates to income or receipts, and also expenses and interest but in a different context. Thus, Section 37(1) and Chapter X provisions pertain to different fields.

56. Chapter X of the Act being a specific statutory provision has to be given effect to and in view of the said provisions arm's length price can be determined. The arm's length procedure prescribed in Chapter X, once applicable has to be given full application. Impact of Chapter X of the Act cannot be controlled or curtailed by reference to the allowability of expenditure under Section 37(1) of the Act. As noticed above and subsequently, provisions of Chapter X are applicable to international transactions between two related enterprises. The purpose of determination of arm's length price is to find out the fair and true market value of the transaction and accordingly the adjustment, if required, is made. The said exercise has its own object and purpose.

57. In terms of the aforesaid discussion, question No.2 has to be answered against the assessed and in favour of the Revenue.

58. There are other aspects on which we also agree with the majority judgment of the Tribunal but would not like to deal with them at this stage but would refer to the same when we examine these aspects on merits.

D. Transfer Pricing of International Transactions

59. A significant volume of global trade consists of international transfer of goods, services, capital and intangibles. As per the *United Nations Practical Manual on Transfer Pricing,* 2013, international transfers within MNE group entities which are called intra group transfers are growing steadily and account for more than 30% of the total international transactions. What is actually paid by one entity to another entity in the intra-group transfer is called the transfer price. Such transactions are controlled transactions because they are between two associated or connected enterprises as distinct from uncontrolled transactions which are between two entities which are not associated and operate on arm's length basis. Transfer Pricing adjustment enables the tax administration of a country to correct the transfer price and compute the same on arm's length price, to check, avoid and ensure correct payment of taxes. Arm's length price in simple words means fair market price. The reason is that each entity belonging to MNE is treated as a separate profit centre and every entity should necessarily make profit and loss at arm's length conditions. This is prevented by correcting either under charging or over charging by AE in intra group transactions. The key issue, therefore, in transfer pricing is valuation of the intra group transfers. The arm's length principle as set forth in Article 9 of the OECD Model Convention stipulates that "where conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profit which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, having so accrued, may be

included in the profits of that enterprise and taxed accordingly." The effect transfer pricing order is to determine whether the transfer price is the same price which would have been agreed for by independent enterprises transacting with each other if the price is determined by market forces. In negates the distortions in the international transaction price when the transaction is between the two AEs. In nutshell, the basis of transfer pricing is that each individual entity must be taxed on the basis that they act at arm's length in the transaction with the other AE.

60. The aforesaid transfer pricing exercise is enforced and mandated under the domestic law and in terms of Chapter X of the Act, i.e. the Income Tax Act, 1961 by adopting or applying one of the specified methods. Transfer pricing mechanisms are created under domestic law and each country can formulate detailed domestic legislation to implement and check controlled pricing. Thus, the transfer pricing regulations may differ from country to country. In practice, this is partly true. Growing importance of international trade, globalization and rapid rise in the number of MNEs has resulted in exhaustive and meticulous research and studies in this complex area. The transfer pricing methods have seen a measure of standardization, universal recognition and acceptability. Indian transfer pricing regulations have adopted and benefited, from the international framework. The *OECD Transfer Pricing guidelines for multinational enterprises and tax administration* and *United Nations' Practical Manual on Transfer Pricing* do reflect the international understanding on several aspects relating to transfer pricing. We have taken note and liberally referred to the two guidelines as it is found to be conducive and helpful in deciding the issues. Their relevance has been examined in some detail below.

E. Domestic Law, i.e. the Statutory Provisions of the Act.

61. Sections 92(1), 92(2) and 92C of the Act, are reproduced herein for the sake of convenience,

> "**Computation of income from international transaction having regard to arm's length price.**
>
> **92.** (1) Any income arising from an international transaction shall be computed having regard to the arm's length price.
>
> *Explanation.*—For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.
>
> (2) Where in an international transaction or specified domestic transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.
>
> xxx
>
> **Computation of arm's length price**.
>
> **92C.** (1) The arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:—
>
> (*a*) comparable uncontrolled price method;
>
> (*b*) resale price method;
>
> (*c*) cost plus method;
>
> (*d*) profit split method;
>
> (*e*) transactional net margin method;
>
> (*f*) such other method as may be prescribed by the Board.
>
> (2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:
>
> **Provided** that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction has actually been undertaken does not exceed such percentage [not exceeding three per cent] of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price.

The following third proviso shall be inserted after the second proviso to sub-section (2) of section 92C by the Finance (No.2) Act, 2014, w.e.f. 1-4-2015:

Provided also *that where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply*.

Explanation.—For the removal of doubts, it is hereby clarified that the provisions of the second proviso shall also be applicable to all assessment or reassessment proceedings pending before an Assessing Officer as on the 1st day of October, 2009.

(2A) Where the first proviso to sub-section (2) as it stood before its amendment by the Finance (No. 2) Act, 2009 (33 of 2009), is applicable in respect of an international transaction for an assessment year and the variation between the arithmetical mean referred to in the said proviso and the price at which such transaction has actually been undertaken exceeds five per cent of the arithmetical mean, then, the assessee shall not be entitled to exercise the option as referred to in the said proviso.

(2B) Nothing contained in sub-section (2A) shall empower the Assessing Officer either to assess or reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154 for any assessment year the proceedings of which have been completed before the 1st day of October, 2009.

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that—

(*a*) the price charged or paid in an international transaction [or specified domestic transaction] has not been determined in accordance with sub-sections (1) and (2); or

(*b*) any information and document relating to an international transaction [or specified domestic transaction] have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

> (d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,
>
> the Assessing Officer may proceed to determine the arm's length price in relation to the said international transaction [or specified domestic transaction] in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:
>
> **Provided** that an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.
>
> (4) Where an arm's length price is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined:
>
> **Provided** that no deduction under section 10A [or section 10AA] or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section :
>
> **Provided further** that where the total income of an associated enterprise is computed under this sub-section on determination of the arm's length price paid to another associated enterprise from which tax has been deducted [2][or was deductible] under the provisions of Chapter XVIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise."

62. We are not elaborately exacerbating the said provisions to avoid prolixity and would only refer to specifics relevant to decide the present appeals.

63. Sub-section (1) to Section 92 states that any income arising from an international transaction shall be computed having regard to arm's length price. It includes expense or interest arising from an international transaction. Sub-Section (2) is an adjunct and intrinsically connected with Sub- Section (1) to Section 92. It stipulates that Sub-Section (1) shall be applicable when two or more AEs enter into a mutual agreement or arrangement for allocation, apportionment or contribution to any cost, expense incurred or to be incurred in connection with benefit, service or facility provided or to be provided. An international transaction, therefore, means transaction between two or more AEs when either one or both are non-resident; the transaction should be in nature of

sale, purchase or lease of tangible or intangible property or in the nature provision for services or lending of money or any other transaction having bearing on the profits, income, losses or assets. A mutual agreement or arrangement for allocation of expenses would also be an international transaction. Section 92F defines the term "transaction" broadly and is a very wide definition, and we observe, that clause (v) thereof stipulates that an arrangement, understanding or action in concert would be a transaction whether or not such arrangements, etc. are formal or whether or not such arrangements are legally enforceable. Under Section 92 (1) and (2), the cost, expense allocated or apportioned or as the case may be contribution by an AE shall be determined having regard to the arm's length price of such benefit, service or facility.

64. Section 92C(1) is of significance and relevance as it stipulates that arm's length price in relation to an international transaction can be determined by any of the five methods stipulated therein, with authority to the Board to prescribe a sixth method. It is an accepted case that the Board has prescribed such method in Rule 10AB with effect from 1st April, 2012. The five methods are (a) Comparable Uncontrolled Price Method; (b) RP Method, i.e. Resale Price Method; (c) CP Method, i.e. Cost Plus Method; (d) Profit Split Method; and, (e) TNM Method, i.e. Transactional Net Margin Method. Sub-sections (1) and (2) to Section 92C casts obligation on the assessed to compute arm's length price as per the methods prescribed. Consequently, the burden is on the assessed to select and justify the method adopted and the arm's length price declared. Under sub-section (3) to Section 92C, the Assessing Officer can proceed to determine the arm's length price in accordance with Section 92C(1) and (2) on the basis of material, information or documents in his possession, if any of the circumstances mentioned in clauses (a) to (d) are satisfied. The circumstances

being: the price paid or charged for an international transaction has not be determined in accordance with sub-sections (1) and (2); information or documents relating to an international transaction has not been kept or maintained in accordance with the provisions of Section 92D(1) or the Rules; information or data used in computation or arm's length price is not reliable or correct; or the assessed has failed to furnish, within stipulated time, information or document required to be furnished as per notice under sub-section (3) to Section 92D. (See judgment dated 16th December, 2013 in ITA No. 306/2012 titled ***Li & Fung India Pvt. Ltd. vs. Commissioner of Income Tax*** of the Delhi High Court).

Five Methods

65. Comparable Uncontrolled Price Method ('CUP Method', for short) compares price charged for the property or service in a controlled transaction with the price charged for comparable property or service in an uncontrolled transaction in comparable circumstances. In RP Method, the price paid for the product by an independent third party, i.e. the resale price received by an AE is taken as the basis. The arm's length price is computed by a reverse exercise by determining the normal gross profit margin, i.e. gross profit margin, of an unrelated enterprise. Expenses incurred are thereafter, reduced and adjustments for differences in comparables is made to arrive at the arm's length price. This method has been explained below when examining the individual case of M/s Canon India Ltd. and Reebok India Company Ltd. Cost Plus Method ('CP Method', for short) requires determination of the appropriate gross profit margin which would be charged by a comparable and adding the same mark up to the expenditure/cost incurred by the AE to determine the appropriate profit in

view of market conditions and functions performed. The aforesaid thr methods are treated as traditional transactional methods.

66. TNM Method or Profit Split Method are called transactional profit methods or profit based methods. *United Nations' Practical Manual on Transfer Pricing* in paragraph 1.5.10 observes that there is growing acceptance of practical importance of profits based methods. TNM Method has been elucidated in detail below. Profit Split Method takes the combined profit earned by two related parties from one or series of transactions and then divides those profits using economically valid defined basis and aims on replicating the division of profits which would have been anticipated in an agreement made at arm's length. It requires working back from the profit to the price.

Four Steps and Comparables

67. Without specifics and niceties, the steps involved in making a Transfer Pricing adjustment under each of the five methods, will involve four steps:-

a) Ascertain whether there is an international transaction between the assessee and its AE,
b) Ascertain the price at which that transaction has taken place, i.e. the transactional or controlled price,
c) Determine the arm's length price by applying one of the five price discovery methods specified in Section 92, i.e. the uncontrolled price.
d) Compare the transaction price with the arm's length price and make the Transfer Pricing adjustment by substituting the arm's length price for the contract price.

68. The five methods stipulated in sub-section (1) to Section 92C, are set out and articulated step-wise in detail in Rule 10B of the Rules. Be it any of the

five methods, the first step to be exercised is to identify the internatior transaction and the transfer price paid for the same by two AEs. The second step is to carry out functional analysis i.e. the functions to be performed by the two AEs taking into account the assets used, risk assumed, the contractual terms, the economic circumstances of the parties and the business strategy pursued by the parties. On the question of comparability analysis United Nations' Practical Manual on Transfer Pricing in paragraph 5.1.1 states that the analysis is used to designate two distinct but related analytical steps. First being to understand the economic significant characteristic of the controlled transaction between the two AEs and the respective roles of the parties thereto. This has reference to the 5 characteristics i.e. (a) characteristic of property or services transferred; (b) functions performed by the parties taking into account assets employed and risk assumed i.e. functional analysis; (c) contractual terms; (d) economic circumstances and (e) business strategies pursued. The second analytical steps is comparison of those conditions of the controlled transactions with uncontrolled transactions i.e. transactions between the two AEs taking into account the economically significant characteristics of the controlled transactions and the respective roles of the 5 comparability factors. The aforesaid analysis, therefore, requires selection of appropriate comparables i.e. an uncontrolled transaction which is to be compared with a tested party. The comparables can be internal i.e. when one of the AEs enters into a similar uncontrolled transaction with an independent enterprise; or external i.e. involving an independent enterprise in the same market or industry. It is obvious that an internal comparable could in several cases be more dependable and reliable, than an external comparable. A comparable is acceptable, if based upon comparison of conditions a controlled transaction is similar with the conditions in the transactions between independent enterprises. The comparison must be with reference to the comparability analysis as elucidated in paragraph 5.1.1 of the United Nations Practical Manual on Transfer Pricing. In other words, the economically relevant characteristics of the two transactions being compared must be sufficiently comparable. This entails and implies that difference, if any, between controlled and uncontrolled transaction, should not materially affect the conditions being examined given the methodology being adopted for determining the price or the margin. When this is not possible, it should be ascertained whether reasonably accurate adjustments can be made to eliminate the effect of such differences on the price or margin. Thus, identification of the potential comparables is the key to the transfer pricing analysis. As a sequitur, it follows that the choice of the most appropriate method would be dependent upon availability of potential comparable keeping in mind the comparability analysis including befitting adjustments which may be required. As the degree of the comparability increases, extent of potential differences which would render the analysis inaccurate necessarily decreases.

69. The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* is similarly worded. The selection comparables to be applied to the tested party, therefore, depends upon transfer pricing method, for there should be a degree of features which can be usefully compared for determination of the arm’s length price. The characters would include in cases of transfer of tangible property, the physical features of the property, its quality, reliability, availability, volume or supply and in cases of service, the nature and extent of service and in cases of intangible property, the form of transaction, licensing or sale, the type of property, i.e. trademark, patent, know-how, the duration and degree of patent and anticipated benefits. The function analysis test in selection of the comparables seeks to identify and compare economically significant activities and the responsibilities undertaken, the asset

used and the risk assumed by the parties to the transaction. The functions which an assessee may perform, would include design, manufacturing, assembling, research and development servicing, purchasing, distribution, marketing, advertising, transportation, etc. The principal function performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by the independent comparable enterprise and the tested party. While examining the functions performed, the significance of the functions in terms of their frequency, nature and value to the respective parties is an important factor.

70. Equally important is the question or assumption of risk, for increased risk has to be adequately compensated by increase in return. Similarly, recognition must be given to the economic circumstances in determining the comparable which include geographic location, size of market, extent of competition, position of buyers and sales availability or risk of competitive goods and services, level of demand and supply sold in a particular region, consumer purchasing power, nature and extent of government control, labour and capital, transportation, level of the market, i.e. retail or wholesale and so forth.

The Rules and the analytical steps.

71. Sub-Sections (1) and (2) to Section 92C are applicable to the assessed, as well as the Assessing Officer invoking power under Sub-Section (3) to Section 92C of the Act. As noted above, sub-section (2) to Section 92C stipulates that most appropriate method, out of the methods specified in sub-section (1) shall be applied to determine the arm's length price in the manner as may be prescribed. Rule 10C prescribes the manner for determining the most appropriate method. Rule 10C reads:-

> "**10C.** (1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction *or specified domestic transaction*, and which provides the most reliable measure of an arm's length price in relation to the international transaction *or the specified domestic transaction, as the case may be*.
>
> (2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:—
>
> (*a*) the nature and class of the international transaction *or the specified domestic transaction*;
>
> (*b*) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
>
> (*c*) the availability, coverage and reliability of data necessary for application of the method;
>
> (*d*) the degree of comparability existing between the international transaction *or the specified domestic transaction* and the uncontrolled transaction and between the enterprises entering into such transactions;
>
> (*e*) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction *or the specified domestic transaction* and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
>
> (*f*) the nature, extent and reliability of assumptions required to be made in application of a method."

72. Sub-rule (1) requires ascertainment of facts and circumstances of a particular international transaction and the method, which would provide the most reliable measure of the arm's length price. Sub-rule (2) stipulates that while selecting the most appropriate method, clauses (a) to (f) should be taken into account. Therefore, it would be appropriate and proper for the assessed to indicate why and for what reason the method applied is the most appropriate. Similarly, if the Assessing Officer/TPO disagree, they should stipulate and elucidate the reason for selecting or applying a particular method. Clauses (a) to (f) of sub-rule (2) are wide and prescribe a broad criteria which has reference

to nature and class of the transaction; nature and class of AE entering into t transaction; functions performed by them taking into account asset employed or to be employed and risk assumed. They also refer to availability, coverage and reliability of data necessary for application of the method; degree of comparability between the controlled and uncontrolled transaction and between the enterprises; reliability and accuracy of adjustment, which can be made between the tested and uncontrolled transactions and between enterprises. Lastly and significantly, it refers to nature, extent and reliability of assumption required to be made for application of the method.

73. Rule 10B after elucidating on the five methods, in Sub-rule (2) states that comparability of an international transaction, i.e. the tested transaction, with an uncontrolled transaction shall be judged in the manner stipulated therein. The said Rule reads:-

> “**10B.** xxx
>
> (2) For the purposes of sub-rule (1), the comparability of an international transaction *or a specified domestic 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.”

74. Clause (a) refers to specific characteristics of the property transferred or services provided. Clause (b) refers to functions performed, assets employed or to be employed and risk assumed. Clause (c) makes reference to contractual terms whether in writing or otherwise and to responsibilities, risk and benefits divided between the respective parties to the transactions. Clause (d) refers to the conditions prevailing in the markets of the respective parties to the transactions, overall economic development and level of competition and whether or not the markets are wholesale or retail.

75. Equally significant is sub-rule (3) to Rule 10B, which reads:-

> "**10B.** (3) An uncontrolled transaction shall be comparable to an international transaction *or a specified domestic 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."

To understand sub-rule (3), one must account for the definition of the term, "uncontrolled transaction". Rule 10A in clause (a) defines the term, "Uncontrolled transaction" for Rules 10B to 10E, as transactions between enterprises other than AEs, whether resident or non-resident. The term "associated enterprises" has been defined in Section 92A of the Act. The uncontrolled transactions may be between residents or non-residents. This is immaterial. However, they should not be between two AEs. They should be between two independent enterprises. Sub-rule (3) to Rule 10B requires that the transactions should be similar in the manner that the differences between the transaction being compared or between the enterprises entered into, should not materially affect the price or the cost charged or profits arising from such transactions in open market. Uncontrolled transaction can be also treated as comparable, when reasonably adequate adjustments can be made to eliminate material effect of difference(s).

76. It must be stated that transfer pricing is not an exact science but a method of legitimate quantification which requires exercise of judgment on the part of the tax administration and the taxpayer. It is method and formula based and, therefore, is rational and scientific. However, not being perfect or infallible, first and the second proviso to sub-section (2) along with stipulations in Sub-section (2A) and 2(B) of section 92C posit a 'getaway' clause when the arm's length price so determined and the controlled price does not exceed 5%(reduced to 3% w.e.f. 1st April, 2012). In such cases the actual price paid or received by the assessed from the foreign AE is not disturbed. In other cases, the transaction price gets substituted with the arm's length price so determined. Sub-section 2A to Section 92C was inserted by the Finance Act, 2012 with retrospective effect from 1st April, 2002. It states that where the arm's length price determined under sub-section (1) exceeds the arm's length price as declared by 5%, the assessee would not be entitled to exercise the option under first proviso to sub-section (2) as it stood before its amendment by the Finance (No.2) Act, 2009. The "gateway" of 5% or 3%, as the case may be, can be applied if the variation in arm's length price and transaction/controlled price does not exceed the specified percentage. Sub-section (2A), therefore, stipulates that where the difference exceeds the prescribed percentage, the assessee would not be entitled to exercise the option under the first proviso to sub-section (2) to Section 92C and claim reduction. Similarly, the first proviso to Section 92C stipulates that where more than one price is determined by most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices.

77. As a concept and principle Chapter X does not artificially broade , expand or deviate from the concept of “real income”. “Real income”, as held by the Supreme Court in ***Poona Electricity Supply Company Limited versus CIT***, [1965] 57 ITR 521 (SC), means profits arrived at on commercial principles, subject to the provisions of the Act. Profits and gains should be true and correct profits and gains, neither under nor over stated. Arm’s length price seeks to correct distortion and shifting of profits to tax the actual income earned by a resident/domestic AE. The profit which would have accrued had arm’s length conditions prevailed is brought to tax. Misreporting, if any, on account of non-arm’s length conditions resulting in lower profits, is corrected.

78. The aforesaid methods are systematic and methodical and in spite of prescription, there is an element of discretion and flexibility involved in selection of appropriate method, selection of comparable, functional analysis or adjustments. This play in the joints and latitude is required and necessitated as arm’s length price is not purely a mathematical formula but a balanced and rational exercise. The core object and purpose behind the said exercise is to determine the fair market price of a transaction, had the transaction been between two independent entities. Under the same method, we can reach different arm’s length prices by relying upon variable factors and assumptions for the purpose of analysis. We should be more concerned and focused on reasonableness of the result for the determination is to ascertain a fair and just result.

G. Section 92(3) of the Act and Bundled / Inter-Connected Transactions

79. At this stage and before we examine the TNM Method exhaustively, we deem it necessary to interpret and refer to in some detail sub-section (1) to Section 92C and reference to the term ‘transaction’ with the vowel ‘an’, which has been interpreted by the majority judgment of the Tribunal to mean a single

independent transaction and not a group or bundle of transactions. We do n think that use of vowel ‘an’ or the word ‘transaction’ instead of the word ‘transactions’ should be given undue notability and prominence. One of the primary rules of statutory construction is that singular includes plural and vice-versa. This rule applies unless a contrary intention is manifest and exhibited. Merely because a statutory provision is drafted in singularity as opposed to plurality, is not enough to exclude application of the general rule that singular includes plural. The rule is not to be discarded on the ground that the relevant provision is singular or plural and the subsidiary and ancillary provision follow the same pattern. Contrary intention to exclude this generic rule is not to be lightly inferred. Contrary intention is not assumed or formed by confining attention to a specific provision but it would be apposite to consider the provision in the setting and placement of the legislation. It is a substance and tenure of the statute which would be meaningfully and critically determinative. This is the mandate of Section 13(2) of the General Clauses Act, 1897 (see ***Newspapers Ltd. versus State Industrial Tribunal*** AIR 1957 SC 532, ***Narshimha Murthy versus Susheelabai*** 1996 (4) SCC 644, ***J. Jayalalitha versus Union of India*** (1999) 5 SCC 138, ***Blue Metal Industries Ltd versus RW Dilley*** (1960) 3 All ER 437, ***Floor versus Davis (Inspector of Taxes)*** (1979) 2 All ER 677, ***Sin Poh Amalgamated (H.K.) Ltd versus Attorney-General*** (1965) 1 All ER 225 (PC))

80. The use of expression ‘class of transaction’, ‘functions performed by the parties’ in Section 92C(1) illustrates to the contrary, that the word ‘transaction’ can never include and would exclude bundle or group of connected transactions. More important would be reference to meaning of the term ‘transaction’ in Section 92F, clause (v), which as per the said definition includes an arrangement or understanding or action in concert whether or not the same is

formal or in writing, whether or not it is intended to be enforceable by leg proceedings. Rule 10A in clause (d) states that "for the purpose of this Rule and Rules 10AB and 10E", the term 'transaction' would "include a number of closely linked transactions". This Rule in positive terms declares that the legislative intent is not to deviate from the generic rule that singular includes plural. The meaning or definition of the expression 'transaction' in clause (d) to Rule 10A read with sub-section (1) to Section 92C, therefore, does not bar or prohibit clubbing of closely connected or intertwined or continuous transactions. This is discernible also from sub-rule (2) to Rule 10B quoted above. The sub-rule refers to 'services provided', 'functions performed', 'contractual terms (whether or not such terms are formal or in writing) of the transactions' which lay down explicitly or impliedly the responsibilities, risks and benefits to be divided between the respective parties to the transactions. Use of plurality by way of necessity and legislative mandate is evident in the said Rule.

81. Similarly, sub-rule (3) to Rule 10B refers to transactions being compared or comparison of the enterprises entering into such transactions likely to affect the price or cost charged etc. A reading of Rule 10C reassures and affirms that the general principle of plurality is not abandoned or discarded.

82. There is considerable tax literature and text that CUP Method, i.e. Comparable Uncontrolled Price Method, RP Method, i.e. Resale Price Method and CP Method, i.e. Cost Plus Method can be applied to a transaction or closely linked, or continuous transactions. Profits Split Method and TNM Method grouped as 'transactional profit methods', can be equally effective and reliable when applied to closely linked or continuous transactions. Thus, it would be inappropriate to proceed with the arm's length computation methods, with a pre-conceived suppositions on singularity as a statutory mandate. Clubbing of

closely linked, which would include continuous transactions, may permissible and not ostracized. Aggregation of closely linked transactions or segregation by the assessed should be tested by the Assessing Officer/TPO on the benchmark and the exemplar; whether such aggregation/ segregation by the assessed should be interfered in terms of the four clauses stipulated in Section 92C(3) of the Act, read with the Rules. It would, among other aspects, refer to the method adopted and whether reliability and authenticity of the arm's length determination is affected or corrupted.

83. We now proceed to examine the TNM Method, whether there is prohibition in applying this method on entity to entity basis, and if not, when is it permissible to apply entity to entity comparison. The discussion would also answer the question, when is clubbing or bunching or transactions permissible in TNM Method.

H. TNM Method Enunciated

84. The TNM Method is elucidated in clause (e) to Rule 10B(1) of the Rules. We are reproducing the said Rule as it has been applied by the assessees in several cases and the TPO has also accepted application of the said method, but treated the AMP expenses as an independent transaction, a finding upheld by the majority judgment in ***L.G. Electronics India Pvt Ltd.*** (supra) and in the present cases. Clause (e) to Rule 10B(1) reads:

> "**10B.** (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction *or a specified domestic transaction* shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—
>
> **xxx**
>
> (e) transactional net margin method, by which,—
>
> (i) the net profit margin realised by the enterprise from an international transaction *or a specified domestic transaction* entered into with an

> associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
>
> (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;
>
> (iii) the net profit margin referred to in sub-clause (*ii*) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction *or the specified domestic transaction* and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
>
> (iv) the net profit margin realised by the enterprise and referred to in sub-clause (*i*) is established to be the same as the net profit margin referred to in sub-clause (*iii*);
>
> (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction *or the specified domestic transaction*"

85. Sub-clause (i) refers to net profit margin realized by an enterprise from an AE in an international transaction which could be with reference to cost incurred; sales affected; assets employed or to be employed in an enterprise or having regard to any other base. Thus, Sub-clause (1) refers to net profit in proportion to the selected base. The appropriate base is referred to as the Profit Level Indicator ('PLI', for short). Generally, the net profit is applied with reference to sales, i.e. operating profit margin; operating expenses, also referred to as the berry ratio; and operating assets, i.e. return on capital. Clause (i) above, gives a wider selection choice by stipulating an optional base with reference to any other base. The selection, it is obvious, must be appropriate.

86. Under sub-clause (ii), the net profit margin realized from a comparable uncontrolled transaction or a number of such transactions is computed having regard to one of the base.

87. Under sub-clause (iii), the net profit margin computed under sub-clau (ii) has to be adjusted by taking into account difference, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which would affect the amount of net profit margin in the open market. Sub-clause (iii) permits subjective adjustments required with reference to differences, if any, between the controlled and uncontrolled transaction, which would materially affect the net profit margin in the open market.

88. Under sub-clause (v), net profit margin thus established, is taken to arrive at an arm's length price in relation to the international transaction.

89. The TNM Method has seen a transition from a disfavoured comparable method, to possibly the most appropriate Transfer Pricing method due to ease and flexibility of applying the compatibility criteria and enhanced availability of comparables. Net profit record/data is assessable and within reach. It is readily and easily available, entity-wise in the form of audited accounts. The TNM Method is a preferred transfer pricing arm's length principle for its proficiency, convenience and reliability. Ideally, in TNM Method preference should be given to internal or in-house comparables. In absence of internal comparables, the taxpayer can and would need to rely upon external comparables, i.e. comparable transactions by independent enterprises. For several reasons, database providers, it is apparent, have the requisite information and data of external comparables to enable comparability analysis of the controlled and uncontrolled transactions with necessary adjustment to obtain reliable results under TNM Method. This method also works to the benefit and advantage of the tax authorities in view of convenience and easier availability of data not only from third party providers, but on their own level, i.e. assessment records of other parties.

90. The strength of the TNM Method is that net profit indicators are le affected by transactional differences in comparison with some other methods. This method is more tolerant to functional differences between controlled and uncontrolled transactions in comparison with resort to gross profit margins. Yet the net profit indicators have potentiality to introduce an element of volatility, primarily for two reasons. Firstly, factors which do not affect gross profit margin and prices can influence net profit indicators due to variation of operating expenses or vice-versa. This potentiality has reference to variation in operational expenses including AMP expenses. The other factors include tax-payers competitive position in the form of price and margins and in some cases, it may be difficult to eliminate or compute the effect of these factors. These difficulties in applying or accepting the TNM Method arise when there is complexity of functions and each party to the transaction(s) makes valuable unique contribution. Reliability of the TNM Method is sufficiently certain where one of the parties makes all contribution involved in the controlled transaction. This is the position even as per the Revenue's case in the present set of appeals. Revenue has asserted that the Indian subsidiaries, i.e. the assessees are mere dummies which implement, promote and incur AMP expenses for building brand value of the foreign AE. Value addition for the Indian AE is not pleaded or argued. Selection of the TNM Method where adopted by the assessee remains unchallenged by the TPO/Assessing Officer.

91. In case the tested party is engaged in single line of business, there is no bar or prohibition from applying the TNM Method on entity level basis. The focus of this method is on net profit amount in proportion to the appropriate base or the PLI. In fact, when transactions are inter-connected, combined consideration may be the most reliable means of determining the arm's length price. There are often situations where closely linked and connected

transactions cannot be evaluated adequately on separate basis. Segmentati may be mandated when controlled bundled transactions cannot be adequately compared on an aggregate basis. Thus, taxpayer can aggregate the controlled transactions if the transactions meet the specified common portfolio or package parameters. For complex entities or where one of the entities is not 'plain vanilla distributor', it should be applied when necessary and applicable comparables on functional analysis, with or without adjustments are available. Otherwise, the TNM Method should not be adopted or applied on account of being an inappropriate method.

92. The majority judgment refers to an example where the Indian AE may have earned actual profit of Rs.140/-, but returned reduced net profit of Rs.120/- as the Indian AE had incurred brand building expenses to the tune of Rs.20/- for the foreign AE, whereas the net profit on sales declared by comparable uncontrolled transactions was Rs.100/- only. Thus, it was observed that the costs including AMP expenses are independent of cost of imported raw material/finished products having some correlation with overall profit. The example highlights the weakness of the TNM Method. The reasoning would be equally valid, where no AMP or 'brand building' expenses are incurred. (See paragraph 21.8 to 22.10 of the majority decision). The net profit margins can be affected by variation of operating expenses. Thus, the requirement to select appropriate comparable and adjustment. It would be inappropriate and unsound to accept comparables, with or without adjustment and apply TNM Method, and yet conjecturise and mistrust the arm's length price. TNM Method would not be the most appropriate method when there are considerable value additions by the subsidiary AEs. In paragraph 22.9, the majority decision has observed that all costs including the AMP expenses are independent of cost of material. This indicates that the observations have been made with reference to manufacturing

activities. It would not be appropriate and proper to apply the TNM Method case the Indian assessed is engaged in manufacturing activities and distribution and marketing of imported and manufactured products, as interconnected transactions. Import of raw material for manufacture would possibly be an independent international transaction *viz*. marketing and distribution activities or functions. We have earlier used the term ‘plain vanilla distributor’. When we use the words ‘plain vanilla distributor’ we do not mean plain vanilla situations, but value additions and each party making valuable unique contribution.

93. An example given below would make it clear:

Particulars	**Case 1**	**Case 2**
Sales	1,000	1,000
Purchase Price	600	500
Gross Margin	400 (40%)	500 (50%)
Marketing, Sale Promotion expenses	50	150
Overhead expense	300	300
Net profit	50 (5%)	50 (5%)

The above illustrations draw a distinction between two distributors having different marketing functions. In case 2, a distributor having significant marketing functions incurs substantial expenditure on AMP, three times more than in case 1, but the purchase price being lower, the Indian AE gets adequately compensated and, therefore, no transfer pricing adjustment is required. In case we treat the AMP expenses in case 2 as Rs.50/-, i.e. identical as case 1 and AMP of Rs.100/- as a separate transaction, the position in case 2 would be:

Particulars	**Case 2**
Sales	1,000
Purchase Price	500
Gross Margin	500

	(50%)
Overhead expenses	300
Marketing expenses	50
Net profit	150 (15%)

It is obvious that this would not be the correct way and method to compute the arm's length price. The purchase price adjustments/set off would be mandated to arrive at the arm's length price, if the AMP expenses are segregated as an independent international transaction. The position may be worse for the assessed, in case the Assessing Officer makes an addition of Rs.100/- and adds 15% thereto by applying CP Method, i.e. Cost Plus Method. Consequently, the addition made would be of Rs.115/-. When Rs.115/- is added to the TNM Method computation of Rs.150/-, it would result in the total income of Rs.265/- or a net profit of 26.5%. Even if the Assessing Officer does not reduce the AMP expenses from Rs.150/- to Rs.50/-, while computing the arm's length price by applying the TNM Method, it would yet result in unacceptable anomaly for the net profit margin would be Rs.50/- plus Rs.115/- or 16.15% instead of 5%. Besides, the said approach would be illogical and unacceptable for AMP expenses when segregated as an independent international transaction, must be treated so in all aspects. These anomalies arise on account of fact that there was no apportionment and division of the transactional compensation, but the packaged transaction has been bifurcated and divided into two. This position is not acceptable as it is irrational and unsound.

94. The example given by the Tribunal refers to efficiencies or better management skills of the assessed AE which is not duly accounted. Albeit, this could be accounted for by way of an adjustment under clause (iii) of Rule 10B(1)(e).

95. Illustratively, as indicated in the majority judgment of the Tribunal r profit margin would undergo a change in case the operating expenses are different in case 1 and case 2, as these relate to operational costs and expenses incurred. Better and more efficient management or other valid ground or contrarily could justify the difference. If there is substantial difference in the said figure which cannot be justified and explained, suitable adjustment is permissible and allowed under clause (iii) of Rule 10B(1)(e). If the said adjustment is made, and the actual net profit margin is computed, the difference of Rs.20/- as pointed out by the majority judgment of the Tribunal would not arise. In the alternative, the comparable or even TNM Method can be rejected.

96. The United Nations' Practical Manual on Transfer Pricing in paragraph 6.3.12.1 acknowledges that TNM Method is usually applied to broad comparable functions, rather than broad controlled transactions. Return on these functions when measured with the PLI base in proportion to the net profit margins, would get affected by factors unrelated to arm's length pricing, which is a negative factor, and for this reason TNM Method is typically applied when the related parties are engaged in continuous series of transactions and one of the parties controls intangible assets for which arm's length price/return is not easy to determine. It is favourable to apply TNM Method when one party is performing routine marketing, distribution and other functions that do not involve control over intangible assets as it allows appropriate return to the party controlling unique or difficult to value intangible assets. Success or efficacy of a particular method would depend upon functional analysis of the tested party and the comparable. Once we accept the comparable on the basis of functional analysis and if required, after making adjustments, then there should be no difficulty in accepting the international transfer price. In case of discrepancy, addition may be justified where the net profit margin declared in the case of the

tested party is lower than the comparable. A comparable should be accepted it deals with the same or identical or similar property under the same or substantially the same circumstances as the controlled transaction so as to give reliable and more certain measure of arm's length result. All methods including the TNM Method acknowledge that there could be difference between tested part and the comparable on functional analysis, but this would not be material where it is possible to reasonably ascertain the effect on account of the differences for which appropriate adjustments can be made. Thus, selection of the comparable depends upon the functional analysis, similarity as to the several factors and whether or not it is possible to make adjustments to account for the material differences in such circumstances to accept or reject a comparable. Selection of the appropriate comparable ensures similar profit potential and accordingly taxation of the subsidiary AE in the country of its residence.

97. We would also reproduce paragraphs 3.9 to 3.12 of Chapter 3; comparability analysis from *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* which reads as under:

> "3.9 Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Examples may include 1. Some long-term contracts for the supply of commodities or services, 2. Rights use intangible property, and. *3.* pricing a range of closely linked products *(e.g.* in a product line) when it is impractical to determine pricing for each individual product or transaction. Another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually. Such transactions should be evaluated together using the most appropriate arm's length method. A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part in its entirety, rather than consider the individual transactions on a separate basis.

3.10 Another example where a taxpayer's transactions may be combined is related to portfolio approaches. A portfolio approach is a business strategy consisting of a taxpayer bundling certain transactions for the purpose of earning an appropriate return across the portfolio rather than necessarily on any single product within the portfolio. For instance, some products may be marketed by a taxpayer with a low profit or even at a loss, because they create a demand for other products and/or related services of the same- taxpayer that are then sold or provided with high profits (e.g. equipment and captive aftermarket consumables, such as vending coffee machines and coffee capsules, or printers and cartridges). Similar approaches can be observed in various industries. Portfolio approaches are an example of a business strategy that may need to be taken¯into account in the comparability analysis and when examining the reliability of comparables. See paragraphs 1.59-1.63 on business strategies. However, as discussed in, paragraphs 1.70-1.72, these considerations will not explain continued overall losses or poor performance over time. Moreover, in order to be acceptable, portfolio approaches must be reasonably targeted as they should not be used, to apply a. transfer pricing method at the taxpayer's company-wide level in those cases where different transaction's. have different economic logic and should be segmented. See paragraphs 2.78 - 2.79. Finally, the above comments. should not be misread as implying that it would be acceptable for one entity within an - MNE group to have a below arm's length return in order to provide benefits to another entity of the MNE group, see in particular paragraph 1.71.

3.11 While some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm's length, other transactions contracted between such enterprises as a package may need to be evaluated separately. An MNE may package as a single transaction and establish a single price for a number of benefits such as licences for patents, know-how, and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as package deal. Such comprehensive packages would be unlikely to include sales of goods, however, although the price charged for sales of goods may cover some accompanying services. In some cases, it may not be feasible to evaluate the package as a whole so that the elements of the package must be segregated. In such cases, after determining separate transfer pricing for the separate elements, the tax administration should nonetheless consider whether in total the transfer pricing for the entire package is arm's length.

3.12 Even in uncontrolled transactions; package deals may combine elements that are subject to different tax treatment under domestic law or an income tax convention. *For example, royalty payments may be subject to withholding tax but lease payments* may be subject to net taxation. In such circumstances; it may still be appropriate to determine the transfer pricing on a package basis, and the tax administration could then determine whether for other tax reasons it is necessary to allocate the price to the elements of the package. In making this determination, tax administrations should

> examine the package deal between associated enterprises in the same way that they would analyze similar deals between independent enterprises. Taxpayers should be prepared to show that the package deal reflects appropriate transfer pricing."

98. Paragraph 3.9 at the outset states that ideally in order to arrive at more precise approximation, the arm's length computation should be made on transaction to transaction basis. But this valuation may not possible on separate basis where there are separate transactions which are closely linked and continuous. Paragraph 3.11 referred to package deal specially in cases where the transaction between two AEs is in form of one single agreement with number of arrangements. Paragraph 3.12 acknowledges the effect of domestic law or double taxation avoidance agreement which may mandate different tax treatments to a particular type of income or tax event. In such cases it would be appropriate to segregate the transactions.

99. Paragraph 3.12 of the OECD guidelines quoted above also refers to allocation of price elements of a package or bundle of transactions. It recommends that segregation should be done in a way that the tax administration must be able to analyse similar deals between independent enterprises. This aspect of segregation has been examined separately.

100. The TPO/Assessing Officer can overrule the assessee as to the method adopted and select the most appropriate method. The reasons for selecting or adopting a particular method would depend upon functional analysis, comparison, which requires availability of data of comparables performing of similar or suitable functional tasks in a comparable business. When suitable comparables relating to a particular method are not available and functional analysis or adjustments is not possible, it would be advisable to adopt and apply another method. This would mean in the example given above, if the Assessing Officer/TPO notices that operating expenses in the case of the tested party are

substantially lower than the comparable or indicative of greater and bett efficiency, he can make suitable adjustments and then compute the operating profit. In case it is not possible to make adjustment, he may reject the method selected by the assessed and adopt another method. Several recourses may be available. Of course, justification and reasons must be stated and elucidated.

101. However, once the Assessing Officer/TPO accepts and adopts TNM Method, but then chooses to treat a particular expenditure like AMP as a separate international transaction without bifurcation/segregation, it would as noticed above, lead to unusual and incongruous results as AMP expenses is the cost or expense and is not diverse. It is factored in the net profit of the inter-linked transaction. This would be also in consonance with Rule 10B(1)(e), which mandates only arriving at the net profit margin by comparing the profits and loss account of the tested party with the comparable. The TNM Method proceeds on the assumption that functions, assets and risk 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.

I. Brand and Brand Building

102. We begin our discussion with reference to elucidation on the concept of brand and brand building in the minority decision in the case of ***L.G. Electronics India Pvt Ltd.*** (supra). The term 'brand', it holds, refers to name, term, design, symbol or any other feature that identifies one seller's goods or

services as distinct from those of others. The word ‘brand’ is derived from t word ‘brandr’ of Old Norse language and represented an identification mark on the products by burning a part.

103. Brand has been described as a cluster of functional and emotional values. It is a matter of perception and reputation as it reflects customers’ experience and faith. Brand value is not generated overnight, but is created over a period of time, when there is recognition that the logo or the name guarantees a consistent level of quality and expertise. Leslie de Chernatony and McDonald have described “a successful brand is an identifiable product, service, person or place, augmented in such a way that the buyer or user perceives relevant, unique, sustainable added values which match their needs most closely.” The words of the Supreme Court in Civil Appeal No.1201/1966 decided on 12th February, 1970 in ***Khushal Khenger Shah versus Mrs. Khorshedbanu Dabida Boatwala,*** to describe ‘goodwill’, can be adopted to describe a brand as an intangible asset being the whole advantage of the reputation and connections formed with the customer together with circumstances which make the connection durable. The definition given by Lord MacNaghten in ***Commissioner of Inland Revenue versus Muller & Co’s Margarine Ltd.,*** 1901 AC 217 (223) can also be applied with marginal changes to understand the concept of brand. In the context of ‘goodwill’ it was observed:

> “It is very difficult, as it seems to me, to say that goodwill is not property. Goodwill is bought and sold every day. It may be acquired. I think, in any of the different ways in which property is usually acquired. When a man has got it he may keep it as his own. He may vindicate his exclusive right to it if necessary by process of law. He may dispose of it if he will — of course, under the conditions attaching to property of that nature..............What is good-will? It is a thing very easy to describe very difficult to define. It is the benefit and advantage of the good name, reputation, and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start. The goodwill of a business must emanate from a

> particular centre or source. However, widely extended or diffused its influence may be, goodwill is worth nothing unless it has power of attraction sufficient to bring customers home to the source from which it emanates. Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here and another element there. To analyse goodwill and split it up into its component parts, to pare it down as the Commissioners desire to do until nothing is left but a dry residuum ingrained in the actual place where the business is carried on while everything else is in the air, seems to me to be as useful for practical purposes as it would be to resolve the human body into the various substances of which it is said to be composed. The goodwill of a business is one whole, and in a case like this it must be dealt with as such. For my part, I think that if there is one attribute common to all cases of goodwill it is the attribute of locality. For goodwill has no independent existence. It cannot subsist by itself. It must be attached to a business. Destroy the business, and the goodwill perishes with it, though elements remain which may perhaps be gathered up and be revived again.............”

104. “Brand” has reference to a name, trademark or trade name. A brand like ‘goodwill’, therefore, is a value of attraction to customers arising from name and a reputation for skill, integrity, efficient business management or efficient service. Brand creation and value, therefore, depends upon a great number of facts relevant for a particular business. It reflects the reputation which the proprietor of the brand has gathered over a passage or period of time in the form of widespread popularity and universal approval and acceptance in the eyes of the customer. To use words from ***Commissioner of Income Tax versus Chunilal Prabhubas & Co.*** AIR 1971 Cal 70, it would mean :

> “… It has been horticulturally and botanically viewed as “a seed sprouting” or an “acorn growing into the mighty Oak of goodwill”. … It has been historically explained as growing and crystallising traditions in the business. It has been described in terms of a magnet as the “attracting force”. In terms of comparative dynamics, goodwill has been described as the “differential return of profit.” Philosophically it has been held to be intangible, Though immaterial, it is materially valued. Physically and psychologically, it is a “habit” and sociologically it is a “custom”. Biologically, it has been described by Lord Macnaghten in *Trego* v. *Hunt*, 1896 AC 7 as the “sap and life” of the business. It has been horticulturally and botanically viewed as “a seed sprouting” or an “acorn growing into the mighty Oak of goodwill”. It has been geographically described by locality. It has been historically explained as

> growing and crystallising traditions in the business. It has been described in terms of a magnet as the "attracting force". In terms of comparative dynamics, goodwill has been described as the "differential return of profit." Philosophically it has been held to be intangible, Though immaterial, it is materially valued. Physically and psychologically, it is a "habit" and sociologically it is a "custom". Biologically, it has been described by Lord Macnaghten in *Trego* v. *Hunt*, 1896 AC 7 as the "sap and life" of the business."

105. There is a line of demarcation between development and exploitation. Development of a trademark or goodwill takes place over a passage of time and is a slow ongoing process. In cases of well recognised or known trademarks, the said trademark is already recognised. Expenditures incurred for promoting product(s) with a trademark is for exploitation of the trademark rather than development of its value. A trademark is a market place device by which the consumers identify the goods and services and their source. In the context of trademark, the said mark symbolises the goodwill or the likelihood that the consumers will make future purchases of the same goods or services. Value of the brand also would depend upon and is attributable to intangibles other than trademark. It refers to infrastructure, know-how, ability to compete with the established market leaders. Brand value, therefore, does not represent trademark as a standalone asset and is difficult and complex to determine and segregate its value. Brand value depends upon the nature and quality of goods and services sold or dealt with. Quality control being the most important element, which can mar or enhance the value.

106. Therefore, to assert and profess that brand building as equivalent or substantial attribute of advertisement and sale promotion would be largely incorrect. It represents a coordinated synergetic impact created by assortment largely representing reputation and quality. There are a good number of examples where brands have been built without incurring substantial advertisement or promotion expenses and also cases where in spite of extensive

and large scale advertisements, brand values have not been created. Therefore, it would be erroneous and fallacious to treat brand building as counterpart or to commensurate brand with advertisement expenses. Brand building or creation is a vexed and complexed issue, surely not just related to advertisement. Advertisements may be the quickest and effective way to tell a brand story to a large audience, but just that is not enough to create or build a brand. Market value of a brand would depend upon how many customers you have, which has reference to brand goodwill, compared to a baseline of an unknown brand. It is in this manner that value of the brand or brand equity is calculated. Such calculations would be relevant when there is an attempt to sell or transfer the brand name. Reputed brands do not go in for advertisement with the intention to increase the brand value, but to increase the sales and thereby earn larger and greater profits. It is not the case of the Revenue that the foreign AEs are in the business of sale/transfer of brands.

107. Accounting Standard 26 exemplifies distinction between expenditure incurred to develop or acquire an intangible asset and internally generated goodwill. An intangible asset should be recognised as an asset, if and only if, it is probable that future economic benefits attributable to the said asset will flow to the enterprise and the cost of the asset can be measured reliably. The estimate would represent the set off of economic conditions that will exist over the useful life of the intangible asset. At the initial stage, intangible asset should be measured at cost. The above proposition would not apply to internally generated goodwill or brand. Paragraph 35 specifically elucidates that internally generated goodwill should not be recognised as an asset. In some cases expenditure is incurred to generate future economic benefits, but it may not result in creation of an intangible asset in form of goodwill or brand, which meets the recognition criteria under AS-26. Internally generated goodwill or

brand is not treated as an asset in AS-26 because it is not an identifiat resource controlled by an enterprise, which can be reliably measured at cost. Its value can change due to a range of factors. Such uncertain and unpredictable differences, which would occur in future, are indeterminate. In subsequent paragraphs, AS-26 records that expenditure on materials and services used or consumed, salary, wages and employment related costs, overheads, etc. contribute in generating internal intangible asset. Thus, it is possible to compute goodwill or brand equity/value at a point of time, but its future valuation would be perilous and an iffy exercise.

108. In paragraph 44 of AS-26, it is stated that intangible asset arising from development will be recognised only and only if amongst several factors, it can demonstrate a technical feasibility of completing the intangible asset so that it will be available for use or sale and the intention is to complete the intangible asset for use or sale is shown or how the intangible asset will generate probable future benefits, etc.

109. The aforesaid position finds recognition and was accepted in ***Commissioner of Income Tax versus B. C. Srinivasa Setty***, (1981) 2 SCC 460 (SC), a decision relating transfer to goodwill. Goodwill, it was held, was a capital asset and denotes benefits arising from connection and reputation. A variety of elements go into its making and the composition varies in different trades, different businesses in the same trade, as one element may pre-dominate one business, another element may dominate in another business. It remains substantial in form and nebulous in character. In progressing business, brand value or goodwill will show progressive increase, but in falling business, it may vain. Thus, its value fluctuates from one moment to another, depending upon reputation and everything else relating to business, personality, business rectitude of the owners, impact of contemporary market reputation, etc.

Importantly, there can be no account in value of the factors producing it and it impossible to predicate the moment of its birth for it comes silently into the world unheralded and unproclaimed. Its benefit and impact need not be visibly felt for some time. Imperceptible at birth, it exits unwrapped in a concept, growing or fluctuating with numerous imponderables pouring into and affecting the business. Thus, the date of acquisition or the date on which it comes into existence is not possible to determine and it is impossible to say what was the cost of acquisition. The aforesaid observations are relevant and are equally applicable to the present controversy.

110. It has been repeatedly held by Delhi High Court that advertisement expenditure generally is not and should not be treated as capital expenditure incurred or made for creating an intangible capital asset. Appropriate in this regard would be to reproduce the observations in ***CIT versus Monto Motors Ltd***, [2012] 206 Taxman 43 (Del), which read:-

> "4. … Advertisement expenses when incurred to increase sales of products are usually treated as a revenue expenditure, since the memory of purchasers or customers is short. Advertisement are issued from time to time and the expenditure is incurred periodically, so that the customers remain attracted and do not forget the product and its qualities. The advertisements published/displayed may not be of relevance or significance after lapse of time in a highly competitive market, wherein the products of different companies compete and are available in abundance. Advertisements and sales promotion are conducted to increase sale and their impact is limited and felt for a short duration. No permanent character or advantage is achieved and is palpable, unless special or specific factors are brought on record. Expenses for advertising consumer products generally are a part of the process of profit earning and not in the nature of capital outlay. The expenses in the present case were not incurred once and for all, but were a periodical expenses which had to be incurred continuously in view of the nature of the business. It was an on-going expense. Given the factual matrix, it is difficult to hold that the expenses were incurred for setting the profit earning machinery in motion or not for earning profits.

(Also see, ***CIT versus M/s Spice Distribution Ltd.***, ITA No.597/2014, decid by the Delhi High Court on 19th September, 2014; and ***CIT versus Salora International Limited***, [2009] 308 ITR 199])

111. Accepting the parameters of the 'bright line test' and if the said parameters and tests are applied to Indian companies with reputed brands and substantial AMP expenses, would lead to difficulty and unforeseen tax implications and complications. Tata, Hero, Mahindra, TVS, Bajaj, Godrej, Videocon group and several others are both manufacturers and owners of intangible property in the form of brand names. They incur substantial AMP expenditure. If we apply the 'bright line test' with reference to indicators mentioned in paragraph 17.4 as well as the ratio expounded by the majority judgment in ***L.G. Electronics India Pvt Ltd*** case (supra) in paragraph 17.6 to bifurcate and segregate AMP expenses towards brand building and creation, the results would be startling and unacceptable. The same is the situation in case we apply the parameters and the 'bright line test' in terms of paragraph 17.4 or as per the contention of the Revenue, i.e. AMP expenses incurred by a distributor who does not have any right in the intangible brand value and the product being marketed by him. This would be unrealistic and impracticable, if not delusive and misleading. (Aforesaid reputed Indian companies, it is patent, are not to be treated as comparables with the assessed, i.e. the tested parties in these appeals, for the latter are not legal owners of the brand name/trademark.)

112. Branded products and brand image is a result of consumerism and a commercial reality, as branded products 'own' and have a reputation of intrinsic believability and acceptance which results in higher price and margins. Trans-border brand reputation is recognized judicially and in the commercial world. Well known and renowned brands had extensive goodwill and image, even before they became freely and readily available in India through the subsidiary

AEs, who are assessees before us. It cannot be denied that the reputed a established brands had value and goodwill. But a new brand/ trade-mark/ trade-name would be relatively unknown. We have referred to the said position not to make a comparison between different brands but to highlight that these are relevant factors and could affect the function undertaken which must be duly taken into consideration in selection of the comparables or when making subjective adjustment, and thus, for computing the arm's length price. The aforesaid discussion substantially negates and rejects the Revenue's case. But there are aspects and contentions in favour of the Revenue which requires elucidation.

J. Bright Line Test

113. The majority decision of the Tribunal holds that excessive AMP expenses beyond the 'bright line test' should be treated as a separate international transaction for promoting the brand owned by the foreign AE. The minority opinion is to the contrary. Discussion on this issue would involve several aspects, whether the TPO/Assessing Officer can apply the 'bright line test' to split the AMP expenses, as essential and non-routine; paragraph 17.6 rejecting AEs of reputed brands as comparables; whether the 'bright line tests' comparables mentioned in paragraph 17.4 of the majority decision are justified and correct; whether the CP Method is the appropriate method; and concept and effect of economic ownership of brand. Discussion under the heading 'I' 'Brand and Brand Building', deals and answers several issues. In order to decide remaining aspects, we would like to reproduce the following relevant paragraphs from the majority judgment:

> "9.10. We do not find any force in the contention of the ld. DR that the mere fact of the assessee having spent proportionately higher amount on advertisement in comparison with similarly placed independent entities be considered as conclusive to infer that some part of the

advertisement expenses were incurred towards brand promotion for the foreign AE. Every businessman knows his interest best. It is for the assessee to decide that how much is to be incurred to carry on his business smoothly. There can be no impediment on the power of the assessee to spend as much as he likes on advertisement. The fact that the assessee has spent proportionately more on advertisement can, at best be a cause of doubt for the AO to trigger examination and satisfy himself that no benefit etc. in the shape of brand building has been provided to the foreign AE. There can be no scope for inferring any brand building without there being any advertisement for the brand or logo of the foreign AE, either separately or with the products and name of the assessee. The AO/TPO can satisfy himself by verifying if the advertisement expenses are confined to advertising the products to be sold in India along with the assessee‘s own name. If it is so, the matter ends. The AO will have to allow deduction for the entire AMP expenses whether or not these are proportionately higher. But if it is found that apart from advertising the products and the assessee‘s name, it has also simultaneously or independently advertised the brand or logo of the foreign AE, then the initial doubt gets converted into a direct inference about some tacit understanding between the assessee and the foreign AE on this score. As in the case of an express agreement, the incurring of AMP expenses for brand building draws strength from such express agreement; in the like manner, the incurring of proportionately more AMP expenses coupled with the advertisement of brand or logo of the foreign AE, gives strength to the inference of some informal or implied agreement in this regard.

9.11. Adverting to the facts of the instant case, it is noticed that the ld. DR has amply shown that the assessee not only promoted its name and products through advertisements, but also the foreign brand simultaneously, which has remained uncontroverted on behalf of the assessee. This factor together with the fact that the assessee‘s AMP expenses are proportionately much higher than those incurred by other comparable cases, lends due credence to the inference of the transaction between the assessee and the foreign AE for creating marketing intangible on behalf of the latter.

9.12. The ld. AR has vehemently argued that when the assessee incurred AMP expenses for its business purpose and recorded them as such, the Revenue went wrong in recharacterizing this transaction by splitting it into two parts, viz., one towards advertisement expenses for the assessee‘s business and second towards the brand building for the foreign AE. He fortified this contention by relying on the judgment of EKL Appliances Ltd. (supra). There is absolutely no doubt that para 17 of the judgment unambiguously lays down that the tax administration should not disregard the actual transaction and substitute other transactions for it. However, it is imperative to note that the proposition laid down in para 17 is not infallible or is not an unexceptionable rule. Caveat has been included in the immediately next para no. 18. Two exceptions have been carved out of the general rule against recharacterization of any transaction as set out in para 17, viz. ―(i) where the economic substance of a transaction differs from its form; and (ii) where the form and substance of the transaction are the same but the arrangements made in relation to the transaction, viewed in their totality differ from those which would have been adopted by the individual enterprise behaving in a commercially rational manner.‖ In our considered opinion, the second exception governs the extant situation, as per which, where the form and substance of the transaction are the same, but arrangements made in relation to transaction viewed in totality differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner. The assessee incurred AMP expenses and explicitly showed them as such. Thus the form of showing the AMP expenses coincides with the substance of the AMP expenses. But the arrangement made in such transaction, viewed in totality, differs from that which would have been adopted by independent enterprises behaving in a commercially rational manner. Though the AMP expenses were shown as such but the overt act of showing such expenses as its own is different from what is incurred by independent enterprises behaving in a commercially rational manner, which unearths the covert act of treating the AMP expenses incurred for the brand building for and on behalf of the foreign AE, as also its own. What is relevant to consider is as to whether an independent enterprise behaving in a commercially rational manner would incur the expenses to the extent the assessee has incurred. If the answer to this question is in affirmative, then the transaction cannot be recharacterized. If, however, the answer is in negative, then the transaction needs to be probed further for determining as to whether its recharacterization is required. Such recharacterization can be done with the help of the ratio decidendi of this judgment itself, being, making a comparison with what `independent enterprises behaving in a commercially rational manner‘ would do, tied with the fact of the assessee also simultaneously advertising the brand of its foreign AE. Reverting to the context of AMP expenses, one needs to find out as to how much AMP expenses would independent enterprises behaving in a commercially rational manner, incur. Once by making such a comparison, the result follows that the Indian AE, prominently displaying brand of its Foreign AE in its advertisements, has incurred expenses proportionately more than that incurred by independent enterprises behaving in a commercial rational manner, then it becomes eminent to recharacterize the transaction of total AMP expenses with a view to separate the transaction of brand building for the foreign AE. Even the United Nations Transfer Pricing Manual, which has only a persuasive value, provides for the allocation of such cost between the MNE and its subsidiaries. We, therefore, hold that in the facts and circumstances of the present case, there is a transaction between the assessee and the foreign AE under which the assessee incurred AMP expenses towards promotion of brand which is legally owned by the foreign entity.

Economic vis-à-vis legal ownership of brand

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10.2. We do not find any weight in the contention put forth about the economic ownership and legal ownership of a brand. It is not denied that there can be no economic ownership of a brand, but that exists only in a commercial sense. When it comes in the context of the Act, it is only the legal ownership of the brand that is recognized. If we accept the contention of the ld. AR that it be held as an economic owner of the brand or logo of its foreign AE for the purposes of the Act and hence expenses incurred for brand building, which is legally owned by the foreign AE, should be allowed as deduction in its hands, then incongruous results will follow. It is patent that a manufacturer does not ordinarily sells its goods directly to the ultimate customers. There is normally a chain of middlemen ending with retailer. Going by that logic and descending in the line, the distributors or wholesalers to whom the assessee sells its goods, also become economic owners of the brand on the parity of reasoning that they also exploit the brand for the purpose of selling the goods to retailers. Similarly the retailers also become the economic owners of the brand on the premise that on the basis of such brand they are selling the goods to the ultimate customers. All these middlemen and the assessee can be considered as economic owners of the brand only in a commercial sense for the limited purpose of exploiting it for the business purpose, which is otherwise legally owned by the foreign AE. Such economic ownership is nothing more than that. Suppose the foreign company, who is legal owner of the brand, sells its brand to a third party for a particular consideration, can it be said that the Indian assessee or for that purpose the wholesalers or retailers should also get share in the total consideration towards the sale of brand because they were also economic owners of such brand to some extent? The answer is obviously in negative. It is only the foreign enterprise who will recover the entire sale consideration for the sale of brand and will be subjected to tax as per the relevant taxing provisions. There can be no tax liability in the hands of the Indian AE or the wholesalers or the retailers for parting with the economic ownership of such brand under the Act. In that view of the matter we are of the considered opinion that the concept of economic ownership of a brand, albeit relevant in commercial sense, is not recognized for the purposes of the Act. The above discussion leads us to irresistible conclusion that the advertisement done by the assessee also carrying the brand/logo of its foreign AE coupled with the fact that it spent proportionately higher amount on AMP expenses, gives clear inference of a `transaction' between the assessee and its AE of building and promoting the foreign brand.

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11.4. However, we are not agreeable with the remaining part of the contention of the ld. AR that the legal character of one enterprise can be altered only where the Revenue positively proves the factum of the

existence of influence of the foreign AE over the affairs of the Indian AE in general or in respect of specific transactions. In fact, it is due to this close relation between AEs of MNC that Chapter-X has been enshrined in the Act as an anti-tax avoidance measure. No doubt AEs in India and abroad are two separate legal entities subject to tax in different tax jurisdictions, but the fact that the economic behaviour of one depends on the wish of the other, can never be totally lost sight of. Due to this factor, it becomes significant to verify as to whether the decisions taken by the Indian AE are influenced by its foreign AE. If any decision taken by the Indian AE is found to be uninfluenced, then the transaction is accepted as such by the Revenue at its face value. If however it turns out that the behavior of the Indian
AE has been influenced by the foreign AE, then there arises a need for adjustment to that extent by removing the effect of such influence. In fact, the transfer pricing provisions (hereinafter also called `the TP provisions') are aimed at discovering, in the first instance, if there is any influence of the foreign AE over transactions between it and its Indian counterpart ; and if the answer is in affirmative, then by unloading the effect of such influence on the transaction. This entire exercise is executed by firstly visualizing the value of an international transaction between the two AEs; then ascertaining the ALP of such transaction; and then eventually computing the total income of the Indian AE having regard to the ALP of the international transaction. Initial burden is always on the assessee to prove that the international transaction with the foreign AE is at arm's length price.

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(V) Cost/Value of transaction

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15.3. The ld. DR countered the submissions put forth for the assessee. It was stated that the bright line test is simply a tool to ascertain the cost of the international transaction and it is wrong to contend that the ALP has been determined by applying the bright line test, which is not a part of the Indian tax law.

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15.6. There can be an international transaction between the assessee and its AE under which the assessee incurs some expenses on behalf of its AE. There arises no difficulty when despite there being no formal agreement, the Indian AE incurs such expenses and keeps them in a separate account. The difficulty arises only when such expenses are either clubbed with certain other expenses incurred for the foreign AE or combined with certain similar expenses incurred by the Indian AE for its own business purpose. It is in such a later situation that the task of separating the costs incurred for the foreign AE and those for the business of the Indian AE, assumes significance. If such expenses in two classes are identifiable, one can separate them with ease. But, when both the expenses are intermingled and otherwise inseparable, then some mechanism needs to be devised for ascertaining the cost of the international transaction, being the amount of expenses incurred for the foreign AE.

15.7. As in the present case the assessee did not declare any cost/value of the international transaction of brand building, it became imperative for the TPO to find out such cost/value by applying some mechanism. In fact, the bright line test in our case is a way of finding out the cost/value of international transaction, which is the first variable under the TP provisions and not the second variable, being the ALP of the international transaction. Bright line is a line drawn within the overall amount of AMP expense. The amount on one side of the bright line is the amount of AMP expense incurred for normal business of the assessee and the remaining amount on the other side is the cost/value of the international transaction representing the amount of AMP expense incurred for and on behalf of the foreign AE towards creating or maintaining its marketing intangible. Now the pertinent question is where to draw such line. If the assessee fails to give any basis for drawing this line by not supplying the cost/value of the international transaction, and further by not showing any other more cogent way of determining the cost/value of such international transaction, then the onus comes upon the TPO to find out the cost/value of such international transaction in some rational manner.

15.8. In the present case, the assessee did not declare any cost/value of the international transaction in the nature of brand building. As such, it fell upon the TPO to find out such amount out of the total AMP expenses incurred by the assessee. In the absence of any assistance from the assessee in determining such cost/value, logically it could have been by first identifying comparable independent domestic cases ; ascertaining the amount of advertisement, marketing and promotion expenses incurred by them and percentage of such AMP expenses to their respective sales ; noting the total AMP expenses incurred by the assessee ; discovering the amount of AMP expenses incurred by the Indian entity for its business purpose, by applying the above percentage of comparable cases to assessee‘s sales. The excess of total AMP expenses over such amount as determined as per the immediately preceding step ought to have been and has been rightly taken as a measure to determine the amount of AMP expenses incurred by the assessee for the brand promotion of foreign AE. In other words, the amount coming up as per the last step is the cost/value of such international transaction.

15.9. The figure so deduced, by applying the above approach, representing the cost/value of the international transaction, in the instant case is `161.21 crore. The TPO impliedly considered the same figure as both representing the cost/value of international transaction and also its ALP. However, the DRP came to hold that mark-up of 13% should also have been applied. In a way, the DRP adopted the cost/value of international transaction at `161.21 crore and computed

> the ALP of such transaction at `182.71 crore. It is this final figure of `182.71 crore which was eventually considered by the AO for making adjustment, against which the assessee has come up in appeal before the tribunal.
>
> 15.10. The fact of the matter is that it is the cost/value of the international transaction at `161.21 crore which has been determined by applying the bright line test. Position would have been different if the ALP of the international transaction would have been determined by invoking bright line test. What is appropriate is the substance of the matter and not the nomenclature given to a transaction. In our considered opinion the name given to the method of computing the cost/value of international transaction, whether bright line test or otherwise, has no significance. Since in the present case it is the cost/value of the international transaction which has been determined by applying the bright line test, the contention raised by the learned counsel in this regard has been rendered without merit.
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> xxx”

Paragraph Nos.17.4 and 17.6 have been quoted above.

114. Revenue during the course of arguments had made reference to the *United Nations Practical Manual on Transfer Pricing for Developing Countries*, Chapter 2 relating to business framework. The said chapter gives exhaustive background material on the MNEs, their cross-border operations, value chain analysis, organisation or legal/commercial structure, etc. In the said chapter, in Figure 2.1, exposits details of Value Chain Analysis of the MNEs and their interaction with third parties including the subsidiaries. The said figure is as under:-

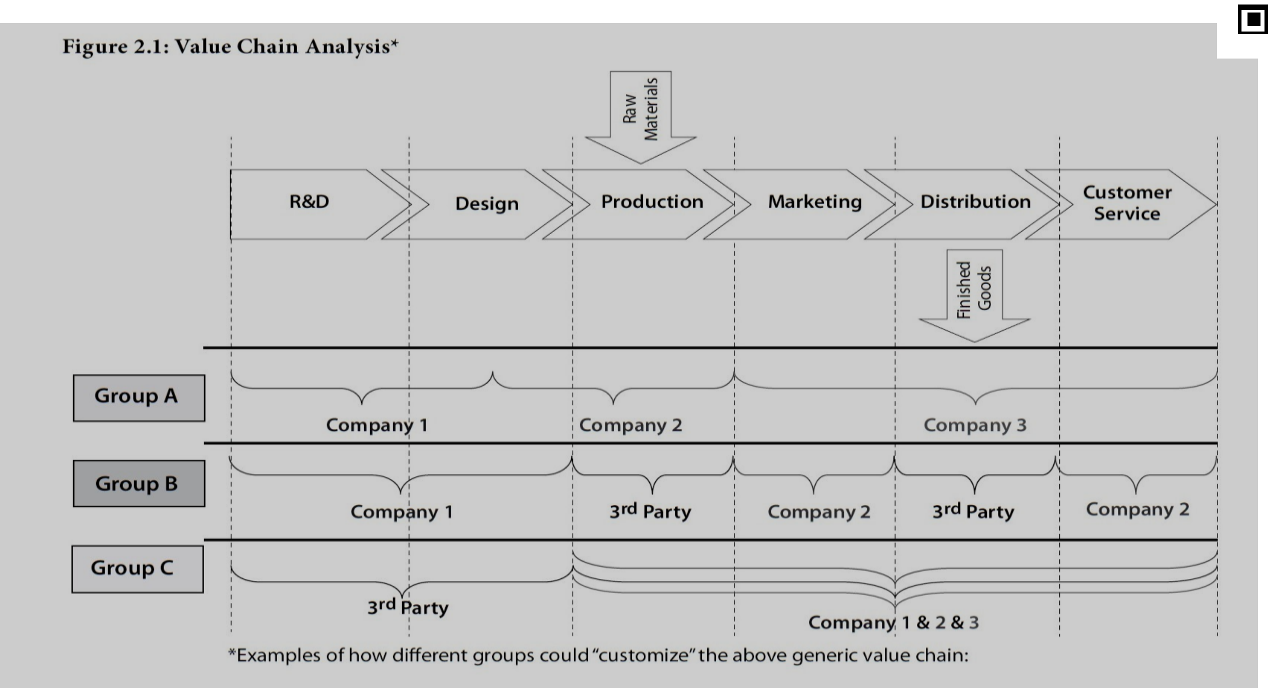
Figure 2.1: Value Chain Analysis*
Raw Materials
R&D
Design
Production
Marketing
Distribution
Customer Service
Finished Goods
Group A
Company 1
Company 2
Company 3
Group B
Company 1
3rd Party
Company 2
3rd Party
Company 2
Group C
3rd Party
Company 1 & 2 & 3
*Examples of how different groups could "customize" the above generic value chain:

115. In the written arguments filed by the Revenue, it is stated that the various MNEs use different business models, sometimes country specific. Some of the common business models used have been elucidated as under:-

> (i) Execute licensing agreements with independent parties for manufacturing the product having brands owned by the MNCs. Since these products have established brands, MNCs charge franchise fees or royalty for use of brands and technology developed by them. Prominent examples of this model are Domino's Pizza being sold by independent party Jubilant Food Works Ltd. or undergarments of Jockey brand sole by Page Industries Ltd.
>
> (ii) Establish a subsidiary for carrying out the distribution function. Examples of this include various appellants before this court.
>
> (iii) Establish a subsidiary for carrying out the distribution and manufacturing function. Maruti Suzuki Ltd. one of the appellants is an example of this business mode.
>
> (iv) Establish a subsidiary for manufacturing the product and use independent companies for distribution. Pepsi Foods Ltd. is an example of this type. It manufactures concentrate which is then sold to bottlers. Some of the bottlers are associated enterprises (AEs) of Pepsi group but some others are independent parties.
>
> (v) Establishment of a subsidiary for carrying out only marketing support services (customers are identified by these subsidiaries and orders are negotiated by the foreign MNC and sales are directly made by foreign MNCs to Indian customers). In these models, the foreign companies invariably

> remunerate the Indian subsidiary with the cost together with some additional fee for such market support activities."

116. It was urged by the Revenue that development of markets for the products is the core function of the entrepreneur, which in this case is the foreign company, an AE. Implementation depends upon the business models of MNEs and how they want this core function to be exercised. Performance of this function clearly benefits the brands and market intangibles owned by the parent company. The test to determine whether the Indian subsidiary was/is incurring the AMP expenses for itself or at the instance of the AE was/is to find out whether an independent party would have undertaken the same level of AMP expenses. An independent party with short-term agreement with an MNE would not incur costs which give long-term benefits of brand and market development advantage to another entity. It is fallacious to contend that brand promotion would benefit an independent entity, for increase in volume of sales largely benefits the manufacturer both in terms of the profit with increased sales and enhanced value to the brand. Benefit to the Indian entity is only marginal or incidental. The contention is that the action of the independent subsidiary amounts to rendering of service to the foreign AE for which arm's length compensation was/is payable. No third party distributor would incur expenditure on development of marketing and brand, which does not eventually belong to it.

117. We have already dealt with and examined the concept of brand as an intangible asset. Routine or day-to-day marketing or sale promotion expenses even, when excessive and exorbitant, would not amount *per se* to "brand building" expenses. The Revenue in the written submissions in fact have accepted in paragraph 8.8 that promotion of products go hand in hand and at most of the times brand is distinguishable from products as only by display of products in a particular manner or emphasis on a particular feature of the

product, the consumer is given the message of what to expect from a giv "brand" (*sic*, product). Hence, it is difficult to compartmentalise promotion of product or promotion of brand expenses and record them as separate from each other. The aforesaid assertions reflect the thin edge and the difficult path Revenue has adopted in bifurcating AMP expenses into marketing or sale promotions and "brand building" by creating and adopting the "bright line test". We have elaborately discussed the concept of term "brand" and "brand building" and observe that it would be incorrect to treat advertisement as equivalent or synonymous with "brand building" for the latter in commercial sense refers to several facets and components. The primary being the quality and reputation of the product or name, which is acquired gradually and silently over a passage of time. The aforesaid arguments fails to notice the fundamental principle of international taxation and Chapter X of the Act that the foreign AE and the Indian AE are two separate tax centres and taxable entities. Profits or enhanced profits consequent to higher manufacturing turnover would be taxed in the hands of the foreign AE, whereas higher profits as a result of increased turnover relatable to distribution and marketing functions would be taxed in the hands of the Indian subsidiary, i.e. the AE. The position would be different if the foreign AE has Permanent Establishment in India. The Revenue has generalised and the argument adopts a universal and ubiquitous approach in the contention that increased turnover would not benefit the Indian AE. The argument is sceptical and conjectural. Moreover, transfer pricing can always correct profit shifting, albeit, by reducing/increasing price/consideration payable to the Indian AE.

118. The Indian subsidiaries in the present case are engaged in distribution and marketing functions of the products manufactured by foreign AEs and in some cases, products are also manufactured by them under license in India. Figure

2.1 refers to the value chain analysis, and treats 'marketing' and 'distribution' two headings, but this does not mean that marketing and distribution functions cannot be combined and treated as one package or a bundle. The functions performed could be both marketing and distribution. Marketing in the form of sale promotion, advertisements, etc. would necessarily involve expenditure both in terms of third party expenditure which the Indian assessee would liable to incur, as also towards the office maintenance and other overhead expenses. Even as one package or a bundle, the Indian subsidiary, i.e. an assessee, must be adequately compensated by adhering to the arm's length price. This is the core of the transfer pricing adjudication. Price paid by or compensation paid to the domestic AE must complement and reciprocate for the functions performed.

119. A pure distribution company would be a comparatively low risk company as compared to a marketing and distribution company. The profits and earnings or arm's length price would accordingly vary. The arm's length price in case of a pure distribution company would enure lower price/profit as compared to a company engaged in distribution and marketing. In most of the cases, distribution and marketing operations would go hand in hand. Marketing itself is a term of wide import and connotation, which includes development of marketing strategy which may have certain common worldwide elements and would normally be the creation and premised by the parent foreign AE but the Indian assessee engaged in marketing operations could devise its own marketing strategies, determine as to the nature and type of advertisements, media selection, timings, etc. Even the choice of products could depend upon local/national conditions. While determining the arm's length price, the issue would be whether or not the Indian assessee is adequately compensated by the foreign AE. The Indian assessee also benefits from the increased sales which results in higher profits and more taxable income in India. AMP, i.e.

advertisements, marketing and sale promotions, therefore, benefit both t Indian AE, i.e. the assessee and the foreign AE resident abroad. Same is true and correct position even in case of a distribution company, though in the said case sales would increase and there would not be any element of AMP. The fact that increased sales benefit the foreign manufacturer is the reason why services of Indian assessees have been engaged by the AEs resident abroad. This argument itself does not show that brand building is being independently undertaken and, therefore, should be treated as a separate international transaction. However, the arm's length computation made both by the assessee as well as the TPO must take into account the AMP expenses.

120. Notwithstanding the above position, the argument of the Revenue goes beyond adequate and fair compensation and the ratio of the majority decision mandates that in each case where an Indian subsidiary of a foreign AE incurs AMP expenditure should be subjected to the 'bright line test' on the basis of comparables mentioned in paragraph 17.4. Any excess expenditure beyond the bright line should be regarded as a separate international transaction of brand building. Such a broad-brush universal approach is unwarranted and would amount to judicial legislation. During the course of arguments, it was accepted by the Revenue that the TPOs/Assessing Officers have universally applied 'bright line test' to decipher and compute value of international transaction and thereafter applied 'Cost Plus Method' or 'Cost Method' to compute the arm's length price. The said approach is not mandated and stipulated in the Act or the Rules. The list of parameters for ascertaining the comparables for applying bright line test in paragraph 17.4 and, thereafter, the assertion in paragraph 17.6 that comparison can be only made by choosing comparable of domestic cases not using any foreign brand, is contrary to the Rules. It amounts to writing and prescribing a mandatory procedure or test which is not stipulated in the Act or

the Rules. This is beyond what the statute in Chapter X postulates. Rules al do not so stipulate. The argument and reasoning in paragraph 17.6 in a way loses focus on the main issue and controversy; whether the arm's length price fixed between the two AEs is adequate and justified and would have been paid if the transaction was between two independent enterprises. The two independent enterprises must be two unrelated parties having no connection. It does not matter whether the comparables are domestic enterprises or not. However, and it is manifest that the comparable should have similar rights, if any, as the tested party in the brand name, trademark, etc.

121. During the course of hearing before us, counsel for the Revenue had submitted that paragraph 17.4 should be treated as illustrations and not as binding comparables. We would prefer to observe, that an Assessing Officer/ TPO can go and must examine the question whether the assessee is performing functions of a pure distributor or performing distribution and marketing functions, in the latter case, he must examine and ascertain whether the transfer price takes into consideration the marketing function, which would include AMP functions. This would ensure adequate transaction price and hence assure no loss of revenue. When the distribution and marketing functions are inter-connected and reliable comparables are available, arm's length price could be computed as a package, if required and necessary by making adequate adjustments. When the Assessing Officer/TPO comes to the conclusion that it is not possible to compute arm's length price without segregating and dividing distribution and marketing or AMP functions, he can so proceed after giving justification and adequate reasons. At that stage, he would have apportioned the price received or the compensation paid by the foreign AE towards distribution and marketing or AMP functions. The TPO can then apply an appropriate method and compute the arm's length price of the two independently and even

by applying separate methods. This will be in terms of the provisions of the A and the Rules and also as per the general principles of international taxation accepted and applied universally. On the other hand, as recorded by us above, applying 'bright line test' on the basis of parameters prescribed in paragraphs 17.4 and 17.6 would be adding and writing words in the statute and the Rules and introducing a new concept which has not been recognised and accepted in any of the international commentaries or as per the general principles of international taxation accepted and applied universally. There is nothing in the Act or the Rules to hold that it is obligatory that the AMP expenses must and necessarily should be subjected to 'bright line test' and the non-routine AMP expenses as a separate transaction to be computed in the manner as stipulated.

122. During the course of hearing, our attention was drawn to United States ISR Regulations, 4.1.2004 Edition, section 1.482-4, Methods to determine taxable income in connection with a transfer of intangible property and also the final regulations 26 CPR Parts 1 and 31 and 602 effective from 31st July, 2009. These are specific regulations framed and applicable in the United States. Care and caution has to be used when we make reference or apply these regulations or interpretation placed by the IRS, in United States of America. 1.482-4 of 2009 Regulations, relating to methods to determine taxable income in connection with transfer of intangible property, elucidates that arm's length consideration for contribution by one controlled taxpayers that develops or enhances the value or may be reasonably anticipated to develop or enhance the value of an intangible property of the other AE, would depend upon several circumstances. If the consideration for such contribution is embedded within the contractual term for the controlled transaction, then ordinarily no separate allocation will be made for such contribution. Thereafter, examples have been given. It stands recorded that the comparability analysis would include

consideration of all relevant factors, including compensation for the activiti performed by the subsidiary and that it is provided in the transfer price, rather than provided by a separate agreement. Reference is also made to requirement to pay royalty and the effect thereof. In 1.482-6, in the context of Profit Split Method, it is recorded that allocation of income to controlled taxpayers, routine contribution will not reflect profit attributable to each controlled taxpayers contribution, but non-routine contribution is not to be accounted for as routine contribution. A non-routine contribution of intangible property may be measured by external benchmarks that reflect the fair market value of such intangible property, or in alternative the relative value of non-routine property contributions may be estimated by capital cost of differentiating the intangible property and all related improvements updates, less an appropriate amount of amortisation based on the useful life of each intangible property. In the present case, none of the parties had applied Profit Split Method and, therefore, the observations in paragraph 1.482-6 would not be of much relevance. Section 1.482-4, however, does state that development or enhancement of intangible property owned by another controlled taxpayer should be accounted for in evaluating the availability of the controlled transaction with comparable transactions. We have quoted the Indian position on the subject under the heading "Brand and brand building". We are not examining and evaluating Profit Split Method. We have accepted the need and postulate of adequate compensation to the domestic AEs for incurring AMP expenses.

123. Australian Income Tax Assessment Act, 1997, as amended up to Act No.124, 213, is lucid and has tangible illustrations. On question of identifying the most suitable method, it is observed that the most appropriate and relevant method should have regard to all factors including respective strength and weaknesses of possible methods in their application to actual conditions, the

circumstances including functions performed, assets used and risk borne by t entities, availability of reliable information required to apply a particular method and degree of comparability between actual circumstances and comparable circumstances, including reliability of adjustments to eliminate the effect of material differences. In identifying comparable circumstances, functions, assets and risk analysis, characteristics of property or services transferred, terms of the relevant contract, economic circumstances and the business strategies of the entities assume importance. Circumstances are comparable to actual circumstances, if and to the extent that the circumstances differ from actual circumstances, when the said difference does not materially affect a condition that is relevant to the method or reasonably adequate adjustment can be made to eliminate the effect of the difference on the condition that is relevant to the method. Illustrations, six in number, draw distinction between long-term distribution or distribution-cum-marketing agreements and short-term contractual arrangements. The resident AEs must be compensated by the foreign AE for the services provided; whether it be in the nature of pure distribution or promotional services; or services as a marketer which also undertakes advertisement and sale promotion expenses resulting in return attributable to marketing intangibles. A long-term pure distributor, who bears no cost or risk of development and market, would not be entitled to any return on the marketing intangibles. Same would be the position in a short-term contract. In case of a long-term contract where marketing expenditures are not abnormal and the resident AE has been proportionately compensated for marketing activities, no separate addition towards compensation is warranted. In cases of long-term contract of exclusive and market distribution rights for a trademark product, where market development activities and extraordinary marketing expenditures are in excess of what comparable independent enterprise with similar rights would incur, adjustment may be required, provided such compensation has not been paid. Reference was made paragraph 6.38 of the OECD Transfer Pricing Guidelines, which stipulate that the said AE might obtain an additional return from the owner of the trademark perhaps through a lower purchase price of the product or reduction in royalty rate. It could also be direct compensation. For distinguishing short-term and long-term contracts, reference has been made to paragraph 3.74 and 2.130 of the 2010 OECD Transfer Pricing Guidelines, to observe that this has to be determined ordinarily based on the conditions existing at the start of the arrangement and, therefore, the consequent effect that a contract is or is not renewed, ordinarily would not be a factor in its initial pricing. This may be otherwise, if there is evidence at the start of the arrangement to indicate that the contract would be renewed. Therefore, in cases of short-term contract, adjustment would be justified, if there is no direct compensation; marketing expenditure incurred is not included in the profit element by reduction of price or royalty payable. This would be accounted for while taking into account the available data about profits of comparable independent enterprises during the corresponding years of similar short-term marketing and distribution agreements. The examples also deal with re-negotiation.

124. There is a difference between a pure and a simple independent distributor and a distributor with marketing rights. An independent distributor with a full marketing right is a person or an entity legally independent of the manufacturer, who purchases goods from the manufacturer for re-sale on its own accounts. The transaction between the two is a straightforward sale in which the distributor takes all economic risk of product distribution and ultimately gains or makes loss depending upon market and other conditions. The manufacturer is not concerned. In case of a low or no risk distributor and he virtually acts as an agent for the loss and gain is that of the manufacturer. There is no economic

risk on distribution of profits. He is, therefore, entitled to fixed remunerati for the self efforts, i.e., relating to the task or function of distribution. Similar will be the position of a low risk distributor with marketing functions, except that the said distributor should be compensated for the marketing, including AMP function. A distributor with marketing function can be normal or a high risk distributor. Such distributors should be compensated but the quantum of compensation would be higher. Such cases have to be distinguished from cases of a true distributor, who is in an independent business, uses his own money for purchasing at a low price and selling at a high price and accordingly shoulders the burden in case of a bad judgment. Profits or losses, therefore, correspond to the risk and market consideration. There is also functional incompatibility between a distributor and a retailer. Retailers cannot be compared with distributor also performing marketing functions. Foreign global enterprises frequently adopt a subsidiary model, i.e. the products are distributed and marketed in a targeted country through a wholly owned subsidiary or a sales subsidiary. A comparable would be an unrelated identity with similar distribution and marketing functions.

125. The United Nations' Manual in Chapter 10 relating to country specific practices notes the Indian stand, but records that the first nine chapters of the Manual provide practical guidance for application of transfer pricing rules based upon Article 9(1) of the U.N. Model Tax Convention and the arms length principle embodied therein. However, there were disagreements on certain points in the sub-committees and Chapter 10 records individual country's view point and experiences for information of readers. This does not reflect a consistent or consensus view of the sub-committee (See paragraph 10.1.1.2)

126. *The United Nations' Manual Transfer Pricing* ***in paragraph 10.4.8.15 records that determination of arm's length price*** in cases of marketing

intangibles ***would involve functional assets analysis of the profile of t Indian entity and the parent company to ascertain whether Indian entity has a risk free, limited risk bearing or risk bearing entity. This mandates identification of the nature, types and stages of development*** of marketing intangibles, ***i.e. whether the foreign parties are new entrants into the Indian market and, therefore, related party in India would incur substantial expenses. Awareness of the trade mark or brand profit or services of the parent company in India, customer loyalty and the brand existence of dealer network whether the Indian entity is to provide after sales service the support, market and customer details, etc.*** It acknowledged that the stand of the Indian tax authorities, who have applied the concept of 'bright line test' of no risk or limited risk distributor or to determine non-routine expenses, has led to multifarious challenges on several account. However, it stands recorded in sub-paragraph No.18 that the important issue in determination of arm's length price is to examine the benefits of the AMP expenditure and whether Indian entities do not receive share of excess profits related to local marketing intangible. Accordingly, the claim of the Revenue is that extraordinary AMP expenditure does not result in appropriate enhancement of profitability of Indian subsidiary or related party. ***The question, therefore, when a subsidiary entity engaged in distribution and marketing incurs AMP expenses, is to ascertain whether the subsidiary AE entity has been adequately and properly compensated for undertaking the said expenditure. Such compensation may be in the form of lower purchase price, non or reduced payment of royalty or by way of direct payments to ensure adequate profit margin. This ensures proper payment of taxes and curtails avoidance or lower taxes of the Indian subsidiary as a separate juristic entity***.

127. We agree and accept the position in the portion reproduced above in bo and italics. The object and purpose of Transfer Pricing adjustment is to ensure that the controlled taxpayers are given tax parity with uncontrolled taxpayers by determining their true taxable income. There should be adequate and proper compensation for the functions performed including AMP expenses. Thus, we disagree with the Revenue and do not accept the overbearing and orotund submission that the exercise to separate 'routine' and 'non-routine' AMP or brand building exercise by applying 'bright line test' of non-comparables and in all case, costs or compensation paid for AMP expenses would be 'NIL', or at best would mean the amount or compensation expressly paid for AMP expenses. Unhesitatingly, we add that in a specific case this criteria and even zero attribution could be possible, but facts should so reveal and require. To this extent, we would disagree with the majority decision in ***L.G. Electronics India Pvt. Ltd.*** (supra).

Decisions in the case of GlaxoSmithKline and DHL

128. In respect of GlaxoSmithKline, very little information is available except that in 1993 an advance pricing agreement was accepted by the IRS and SmithKline Beecham in respect of sale of certain drugs. Glaxo, was then a competitor of SmithKline Beecham and was marketing a similar drug. In 1992, the IRS initiated audit in the case of Glaxo for the years 1989-1990. In 1994, Glaxo and IRS tried to resolve the dispute through advance pricing agreement, but were unsuccessful. The Double Taxation Avoidance Agreement between U.K. and U.S. was invoked. The dispute, it appears was predicated on IRS's assertion that advertisement and marketing was more valuable in respect of the said drug, whereas Glaxo and the U.K. taxing authority believed that the high transfer price was reasonable because the research and development work was more valuable. In December, 2000, Glaxo merged with SmithKline Beecham

Corporation. As noted above, SmithKline Beecham had earlier entered into advance tax agreement with the IRS in respect of the same drug. The terms of the said advance pricing agreement were made public. In 2004, the litigation took another turn, when GlaxoSmithKline sued IRS claiming that they had erred in increasing the assessed income and sought refund along with interest. The matter was scheduled for trial, when on 11th September, 2006, IRS and GlaxoSmithKline announced settlement. GlaxoSmithKline agreed to pay $ 3.4 billion or 60% of the total contested amount and dropped their claim for refund. Noticeably, this was after about 14 years.

129. The dispute in the case of DHL Corporation, U.S.A. in appeal, was decided in favour of the assessed. DHL Corporation, U.S.A. was the registered owner of the trademark and had exclusive right to use and sub-licence DHL trademark in the United States. U.S. Corporation had entered into a long-term agreement with a group company, namely Document Handling Limited International, Hong Kong (‘DHLI’, for short) which was responsible for operations outside the U.S. No royalty was payable to DHL, U.S.

130. In 1992, a third party consortium in terms of an agreement, exercised their option to purchase majority stake in DHLI and another group company, DHLI Middleton, N.V. which owned most of the overseas operating companies. The said consortium, through a new entity created by them, exercised option to purchase DHL trademark rights for US$ 20 million. Several questions arose in the said case including valuation of the trademark rights. One of the contentious issues related to attribution of the sale consideration paid for the trademark between DHL, U.S. and DHLI, Hong Kong.

131. On the question of ownership analysis, the appellate court referred to the plain language of the then governing ‘1968 Regulations’ to observe that legal

ownership was not the proper test, for the 1968 regulations stipulated that t property would be treated as owned by the controlled taxpayer that had borne the greatest share of the cost of development. Thus, the 1968 regulations ignored legal ownership in favour of economic ownership. The '1994 Regulations' superseded the aforesaid effect. Applying the concept of developer-assister rule to the factual matrix, it was observed that DHLI Hong Kong had incurred cost and risk for development of intangibles. Thus, DHLI Hong Kong had the status of a developer.

132. These decisions, contrary to the transfer pricing orders, do not assist or foster Revenue's stand.

Paragraphs 6.36 to 6.39 of the OECD Transfer Pricing Guidelines

133. Transfer Pricing Officers have referred to paragraphs 6.36 to 6.39. For the sake of completeness, we would quote the said paragraphs from the OECD Transfer Pricing Guidelines, which read:-

> "6.36 Difficult transfer pricing problems can arise when marketing activities are undertaken by enterprises that do not own the trademarks or tradenames that they are promoting (such as a distributor of branded goods). In such a case, it is necessary to determine how the marketer should be compensated for those activities. The issue is whether the marketer should be compensated as a service provider, i.e., for providing promotional services, or whether there are any cases in which the marketer should share in any additional return attributable to the marketing intangibles. A related question is how the return attributable to the marketing intangibles can be identified.
>
> 6.37 As regards the first issue- whether the marketer is entitled to a return on the marketing intangibles above a normal return on marketing activities- the analysis requires an assessment of the obligations and rights implied by the agreement between the parties. It will often be the case that the return on marketing activities will be sufficient and appropriate. One relatively clear case is where a distributor acts merely as an agent, being reimbursed for its promotional expenditures by the owner of the marketing intangible. In that case, the distributor would be entitled to compensation

appropriate to its agency activities alone and would not be entitled to share in any return attributable to the marketing intangible.

6.38 Where the distributor actually bears the cost of its marketing activities (i.e. there is no arrangement for the owner to reimburse the expenditures), the issue is the extent to which the distributor is able to share in the potential benefits from those activities. In general, in arm's length transactions the ability of a party that is not the legal owner of a marketing intangible to obtain the future benefits of marketing activities that increase the value of that intangible will depend principally on the substance of the rights of that party. For example, a distributor may have the ability to obtain benefits from its investments in developing the value of a trademark from its turnover and market share where it has a long-term contract of sole distribution rights for the trademarked product. In such cases, the distributor's share of benefits should be determined based on what an independent distributor would obtain in comparable circumstances. In some cases, a distributor may bear extraordinary marketing expenditures beyond what an independent distributor with similar rights might incur for the benefit of its own distribution activities. An independent distributor in such a case might obtain an additional return from the owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate.

6.39 The other question is how the return attributable to marketing activities can be identified. A marketing intangible may obtain value as a consequence of advertising and other promotional expenditures, which can be important to maintain the value of the trademark. However, it can be difficult to determine what these expenditures have contributed to the success of a product. For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. It is also possible that a new trademark or one newly introduced into a particular market may have no value or little value in that market and its value may change over the years as it makes an impression on the market (or perhaps loses its impact). A dominant market share may to some extent be attributable to marketing efforts of a distributor. The value and any changes will depend to an extent on how effectively the trademark is promoted in the particular market. More fundamentally, in many cases higher returns derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures. The actual conduct of the parties over a period of years should be given significant weight in evaluating the return attributable to marketing activities. See paragraphs 3.75-3.79 (multiple year data)."

134. The aforesaid paragraphs do not support the Revenue's submission, b stipulate the requirement that the owner of the marketing intangible should adequately compensate the domestic AE incurring costs towards marketing activities by reimbursement of expenses or by sufficient and appropriate return. Where the domestic AE is entitled to compensation as a pure distributor, it would not be entitled to share in any return attributable to the marketing intangible, not being the legal owner. The position may be different where there is a long-term contract of sole distribution rights of the trade marked products, thereby acquiring "economic ownership" benefit. In some cases, where the distributor bears extraordinary marketing expenses, he would be entitled to additional or higher return, through decreased price or reduction of royalty rate. The difficulty in attributing advertisement and other promotional expenditures towards trademark valuation or towards marketing activities, i.e. contributing to manufacture and current income and the impracticability of division in the case of such attribution is highlighted in paragraph 6.39.

135. It is, therefore, incorrect to suggest or observe that international tax jurisprudence or commentaries recognise "bright line test" for bifurcation of routine and non-routine AMP expenditure, and non-routine AMP expenses is an independent international transaction which should be separately subjected to arm's length pricing.

K. **Aggregation or Disaggregation of Transactions and Set Off in Segregation of Bundled Transactions; whether Section 92(3) prohibits segregation.**

136. This leads us to the question of set off when bundled transactions are segregated. Conceptually, this is justified and equitable, as tax is payable on the

total income after transfer pricing computation in respect of internatior transactions (*See* Section 92(4) of the Act).

137. The question of aggregation and disaggregation of transactions when the TNM Method or even in other methods is sought to be applied, must have reference to the strength and weaknesses of the TNM Method or the applicable method. Aggregation of transactions is desirable and not merely permissible, if the nature of transaction(s) taken as a whole is so inter-related that it will be more reliable means of determining the arm's length consideration for the controlled transactions. There are often situations where separate transactions are intertwined and linked or are continuous that they cannot be evaluated adequately on separate basis. Secondly, the controlled transaction should ordinarily be based on the transaction actually undertaken by the AEs as has been struck by them. We should not be considered as advocating a broad-brush approach but, a detailed scrutinized ascertainment and determination whether or not the aggregation or segregation of transactions would be appropriate and proper while applying the particular Method, is necessary.

138. The OECD Commentary in this regard is relevant and reproduced below:

> "3.13 An-intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions. It occurs when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced to some degree by different benefits received from that enterprise in return. These enterprises may indicate that the benefit each has received should be set-off against the benefit each has provided as full or part payment for those benefits so that only the net gain or loss (if any) on the transactions needs to be considered. for purposes of assessing tax liabilities. For example, an enterprise may license another enterprise to use a patent in return for the provision of know-how in another connection and indicate that the transactions result in no profit or loss to either party. Such arrangements may sometime be encountered between independent enterprises and should be assessed accordance with the arms' length principle in order to quantify the value the respective benefits present as set offs.
>
> 3.14 Intentional set-offs may vary in size and complexity. Such set-offs may range from a simple balance of two transactions. (such as a

> favourable selling price for manufactured goods in. return for a favourable purchase price for the raw material used in producing the goods). To an arrangement for a general settlement balancing all benefits accruing to both parties over a period. Independent enterprises would be very unlikely to consider the latter type of arrangement unless the benefits could be sufficiently accurately quantified and the contract is created in advance. Otherwise, independent enterprises normally would prefer to allow their receipts .and disbursements to flow independently of each other, taking any profit or loss resulting from normal trading.
>
> 3.15 Recognition of intentional set-offs does not change the fundamental requirement that for tax purposes the transfer prices for controlled transactions must be consistent with the arm's length principle. It would be a good practice for taxpayers to disclose the existence of set-offs intentionally built into two or more transactions between associated enterprises and demonstrate (or acknowledge that they have relevant supporting information and have undertaken sufficient analysis to be able to show) that, after taking account of the set-offs, the conditions governing the transactions are consistent with the arm's length principle.
>
> 3.16 It may be necessary to evaluate the transactions separately to determine whether they each satisfy the. arm's length principle. If the transactions are to be analysed together, care should be. taken in selecting comparable transactions and regard had to the discussion at paragraphs 3.9 - 3.12. The terms of set-offs relating to international transactions between associated enterprises may not be fully consistent with those relating to purely domestic transactions between independent enterprises because of the differences in tax treatment of the set-off under different national tax systems or differences in the treatment of the payment under a bilateral tax treaty. For example, withholding tax would complicate a set-off of royalties against sales receipts.
>
> 3.17 A taxpayer may seek on examination a reduction in a transfer pricing adjustment based on an unintentional. over-reporting of taxable income. Tax administrations in their discretion may or may not grant this request. Tax administrations may also consider such-requests in the context of mutual agreement procedures and corresponding adjustments (see Chapter V)."

139. The majority judgment in the case of ***L.G. Electronics India Pvt. Ltd.*** (supra) opines that the Act, i.e. Chapter X of the Act, prohibits and does not permit set off or adjustment. Reference stands made to sub-section (3) to Section 92 of the Act. We would like to reproduce the said Section and understand the object and purpose behind the said provision.

> "(3) The provisions of this section shall not apply in a case where the computation of income under sub-section (1) or sub-section (2A) or the determination of the allowance for any expense or interest under sub-section (1) or sub-section (2A), or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2) or sub-section (2A), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction or specified domestic transaction was entered into."

140. Sub-section (3), we do not think incorporates a bar or prohibits set offs or adjustments. It states that Section 92, which refers to computation of income from international transaction with reference to arm's length price under sub-section (2) or (2A), would not have the effect of reducing income chargeable to tax or increase the loss, as the as may be, computed by the assessee on the basis of entries in the books of account. Income chargeable to tax or loss as computed in the books is with reference to the previous year. The effect of sub-section is that the profit or loss declared, i.e. computed by the assessee on the basis of entries in the books of account shall not be enhanced or reduced because of transfer pricing adjustments under sub-section (2) or (2A) to Section 92. It states the obvious and apparent. In case the assessed has declared better and more favourable results as per the entries in the books of account, then the income chargeable to tax or loss shall not be decreased or increased by reason of Transfer Pricing computation. Thus, transfer pricing adjustments do not enure to the benefit or advantage the assessed, thereby reducing the income declared or enhancing the declared loss. Pertinently, the Sub-Section makes reference to the income chargeable to tax or increase in the loss on the basis of the entries in the books of account. The concept of set off or adjustments was/is well recognized and accepted internationally and by the tax experts/ commentators. In case the legislative intent behind sub-section (3) to Section 92 was to deny set off, the same would have been spoken about and asserted in

different and categorical words. Legislative intent to the contrary should not assumed.

141. Principle of literal interpretation would be applicable for a Section must be construed as it reads, without any addition or subtraction. Constitutional Bench of the Supreme Court in ***CIT versus Vatika Township P. Ltd.*** [2014] 367 ITR 466, has observed:

> "Tax laws are clearly in derogation of personal rights and property interests and are, therefore, subject to strict construction, and any ambiguity must be resolved against imposition of the tax. In Billings v. U. S, the Supreme Court clearly acknowledged this basic and long-standing rule of statutory construction:
>
> "Tax Statutes ... should be construed, and, if any ambiguity be found to exist, it must be resolved in favour of the citizen. Eidman v. Martinez 184 U.S. 578, 583; ...
>
> Again in Unites States v. Merriam, the Supreme Court clearly stated at pages 187-88:
>
> "On behalf of the Government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed, rather than with legal forms or expressions. But, in statutes levying taxes, the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the Government and in favour of the taxpayer. Gould v. Gould 245 U.S. 151, 153."
>
> ASN 51/53 WP-871-14 As Lord Cairns said many years ago in Partington v. Attorney-General: As I understand the principle of all fiscal legislation it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however, great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be."

142. The Legislature, therefore, if it wanted to provide and stipulate that set off would not be available or should be denied, would have appropriately expressed their intention in specific and express words. The intention on the other hand of the Legislature is not what is propounded by the Revenue. Consistent, the stand

of the Revenue, it is apparent is divergent from the internationally accept practice relating to Transfer Pricing determinations. The Legislature when it wanted to deviate, has adopted such recourse as with the year data and use of inter-quartile range. We do not read any repugnancy on this aspect in Section 92(3) of the Act. Thus, where the Act, i.e. the Income Tax Act, 1961 or the Rules do not devise or enact a contrary provision, we should not discard or ignore, without adequate justification, the OECD Transfer Pricing Guidelines or the U.N. Transfer Pricing Manual. Otherwise we deny ourselves benefit and advantage of the study and the dexterous and deliberated elucidations made in the extant OECD Transfer Pricing Guidelines or the U.N. Transfer Pricing Manual, as if they are redundant and superfluous. The Act, i.e. the Income Tax Act, 1961 and the Rules are supreme, but the OECD Transfer Pricing Guidelines or the U.N. Transfer Pricing Manual can be supplement and constitute a valuable and convenient commentary on the subject. They are not binding but surely their rational and articulacy requires cogitation, if not acceptance, when warranted.

143. It may be interesting to reproduce a portion of sub-paragraph (h) of paragraph 3 of the written submissions filed by the Revenue before us which reads:

> "In fact, in a large number of cases the parent companies have reimbursed such expenses to Indian entities either by not charging the royalty, by subvention or by direct subsidy or by reimbursement of expenses. In the light of such glaring facts, the suggestion that the existence of an international transaction is being inferred by the revenue by applying some mathematical tool is not correct."

It should not be understood that we are holding or pronouncing our verdict on the basis of the said written submissions but we have quoted the aforesaid portion to show that the Revenue is conscience and aware of commercial business realities and the need to account for set offs. It is commonly recognized and accepted. The object and purpose behind arm length principle to tax the actual and commercial income which could have been earned by the AE in India.

144. Question of set off would only arise in case two transactions are separate and arm's length price should be computed separately. It would not arise for consideration in cases where there are closely linked or continuous international transactions. Yet, there may be a third category of cases, where the assessee perceives and files his report in form 92E treating the international transaction as one or as continuous or an interconnected package, but the Revenue perceives and believes that the transaction is not one, but should be segregated for the purpose of computation of arm's length price. For the present reasoning, we will assume and accept that the position of the Revenue is correct and the 'aggregation' made by the assessee is wrong. In such cases, it would be grossly unfair and inequitable not to apportion or segregate the transactions as declared in a reasonable and logical manner. It would be conspicuously wrong and incorrect to treat the segregated transactional value as 'NIL' when in fact the two AEs had treated the international transactions as a package or a single one and contribution is attributed to the aggregate package. It is noticeable that sub-section (3) to Section 92 does not make reference to the computation of the form 92E but makes reference to the books of account and computation on the basis of the entries in the books of account. It stipulates that the computation made under sub-section (2) or (2A) shall not have effect of reducing the income or increasing the losses as declared on the basis of the said entries. Income or loss is the net figure which is computed after taking into account the business activities undertaken by the assessed AE which will have reference to the declared bundled/packaged international transaction.

145. In the impugned decision, the majority decision has observed that there no basis for a presumption that the international arm's length price of one transaction was lower and this position has to be proved de hors the overall net profit rate. It should be proved by the assessed by comparison with what was charged for similar goods supplied by other independent enterprises dealing with India. We with respect have reservation and do not agree with the commanding universal affirmative approach. This may be relevant in a given case if the arm's length price is computed transaction by transaction and not as a bundle. Albeit, net profit rate in TNM Method may be indicative, or in a given case, sufficient proof of adequate compensation. Onus would be on the assessed, but the relevant facts must be ascertained. The use of the expression 'special circumstances' etc. in the majority decision is unacceptable. In fact, there cannot be any assumption against the assessed when arm's length price by applying the TNM Method is accepted, to discern and infer that the purchase price did not account and did not subsume the AMP expenses incurred by the Indian AE.

146. Whether higher net profit rate would indicate lower or reduced purchase price, we observe is a question of fact and not law. Subsidy paid could account for the bundled transaction, including the entire set of transactions included. The final finding should be reasoned and analytical. It should be sound as per mathematical and accountancy principles. In case of a package or bunched transaction, this would require forthright and rigorous examination. If bifurcation is legitimate and mandated, apportionment should proceed on accurate and punctilious manner which is fair and reasonable. When the Assessing Officer / the TPO bifurcates or segregates the packaged transaction as declared by the assessed, he must conduct the exercise, rationally and objectively.

CIT versus EKL Appliances Ltd – Disregarding actual transaction

147. Tax authorities examine a related and associated parties' transaction as actually undertaken and structured by the parties. Normally, tax authorities cannot disregard the actual transaction or substitute the same for another transaction as per their perception. Restructuring of legitimate business transaction would be an arbitrary exercise. This legal position stands affirmed in ***EKL Appliances Ltd.*** (supra). The decision accepts two exceptions to the said rule. The first being where the economic substance of the transaction differs from its form. In such cases, the tax authorities may disregard the parties' characterisation of the transaction and re-characterise the same in accordance with its substance. The Tribunal has not invoked the said exception, but the second exception, i.e. when the form and substance of the transaction are the same, but the arrangements made in relation to the transaction, when viewed in their totality, differ from those which would have been adopted by the independent enterprise behaving in a commercially rational manner. The second exception also mandates that actual structure should practically impede the tax authorities from determining an appropriate transfer price. The majority judgment does not record the second condition and holds that in their considered opinion, the second exception governs the instant situation as per which, the form and substance of the transaction were the same but the arrangements made in relation to a transaction, when viewed in their totality, differ from those which would have been adopted by an independent enterprise behaving in a commercially rational manner. The aforesaid observations were recorded in the light of the fact in the case of ***L.G. Electronics*** (supra). Commenting on the factual matrix of ***L.G. Electronics*** case (supra) would be beyond our domain; however, we do not find any factual finding to this effect by the TPO or the Tribunal in any of the present cases. However, in ***L.G.***

Electronics decision (supra), it is observed that if the AMP expenses and wh such expenses are beyond the bright line, the transaction viewed in their totality would differ from one which would have been adopted by an independent enterprise behaving in a commercially rational manner. No reason or ground for holding or the ratio, is indicated or stated. There is no material or justification to hold that no independent party would incur the AMP expenses beyond the bright line AMP expenses. Free market conditions would indicate and suggest that an independent third party would be willing to incur heavy and substantial AMP expenses, if he presumes this is beneficial, and he is adequately compensated. The compensation or the rate of return would depend upon whether it is a case of long-term or short-term association and market conditions, turnover and ironically international or worldwide brand value of the intangibles by the third party.

148. There is no material or data on record to show that an independent enterprise acting in a commercially rational manner would not enter into an agreement for distribution and marketing as has been entered into by the Indian assessee, a subsidiary of the foreign AE. It would be incongruous and presumptuous to hold, without any data or good reason, that the transactions for distribution and marketing as a package are not executed between a foreign enterprise and an independent enterprise. The "bright line test" we hasten to reiterate is not and cannot be the criteria, reason or data. Commercial men would seek appropriate margins to incur AMP expenses and yet earn net profit as per market conditions.

149. The concept of re-categorisation of transaction is not identical or similar to aggregation or segregation of transactions. Re-categorisation of transaction is a different exercise and would result in re-categorisation of the functions and, therefore, accordingly the comparables. A simple example of re-categorisation

would be cases of "thin capitalisation". Aggregation or segregation transactions accepts that the transactions *per se* do not require re-categorisation of transactions. However, in a given case when there is re-categorisation of transaction, as a consequence, segregation or aggregation may be required. However, the two aspects/principles prevail and operate in their own field.

L. **Economic Ownership**

150. Value of tangible property may be affected by the value of intangible property, such as trademark affixed on the tangible property. Transfer of tangible property with embedded intangible property normally is not considered a transfer of such intangible particularly when the controlled purchasers do not acquire any right to exploit the intangible property other than the right to re-sell the tangible property with embedded or affixed intangible rights. However, while computing the arm's length price, the cost or value of the embedded intangible would be relevant when the comparability test is adopted and applied between the controlled transaction with the uncontrolled transactions.

151. Economic ownership of a trade name or trade mark is accepted in international taxation as one of the components or aspects for determining transfer pricing. Economic ownership would only arise in cases of long-term contracts and where there is no negative stipulation denying economic ownership. Economic ownership when pleaded can be accepted if it is proved by the assessed. The burden is on the assessed. It cannot be assumed. It would affect and have consequences, when there is transfer or termination of economic ownership of the brand or trademark.

152. Determination whether the arrangement is long-term with economic ownership or short-term should be ordinarily based upon the conditions existing at the start of the arrangement and not whether the contract is subsequently

renewed. However, it is open to the party, i.e. the assessed, to place eviden including affirmation from the brand owner AE that at the start of the arrangement it was accepted and agreed that the contract would be renewed.

153. Economic ownership of a brand is an intangible asset, just as legal ownership. Undifferentiated, economic ownership brand valuation is not done from moment to moment but would be mandated and required if the assessed is deprived, denied or transfers economic ownership. This can happen upon termination of the distribution-cum-marketing agreement or when economic ownership gets transferred to a third party. Transfer Pricing valuation, therefore, would be mandated at that time. The international transaction could then be made a subject matter of transfer pricing and subjected to tax.

154. Brand or trademark value is paid for, in case of sale of the brand or otherwise by way of merger or acquisition with third parties. Revenue in paragraph 8.9 of the written submissions have referred to acquisition of brand name ‘Reebok’ by ‘Adidas’ and asserted that the entire benefit was reaped by the parent entity and not by Reebok India Company Ltd.. Re-organisation, sale and transfer of a brand as a result of merger and acquisition or sale is not directly a subject matter of these appeals. As noted above, in a given case where the Indian AE claims economic ownership of the brand and is deprived or transfers the said economic ownership, consequences would flow and it may require transfer pricing assessment. In the written submissions filed by Sony India Private Limited, they have accepted the said position and stated as under:-

> “7.8 Two inferences are therefore inevitable- till a brand gets terminated, transferred or sold, its value is measured only in terms of the market share or sales turnover. At the time of the sale, in certain circumstances it becomes an independent standalone transfer of an intangible right commanding a separate value or consideration. As a result of which:

> 7.8.1 The commercial benefit of advertisement or marketing accrues to the appellant/the tested party in India for having promoted the sale of the products in India. Income-tax Act recognises this and therefore allows it as a revenue expense wholly and exclusively expended for the purposes of the business, the said issue has also been upheld by this court in the case of Agra beverages Corporation (P) Ltd vs. CIT [2011] 11 taxmann.com 350 (Refer Page no. 284 of the paperbook)."

M. **Decision in the case of *Maruti Suzuki* and the order of the Supreme Court**

155. With respect, the majority judgment of the Tribunal has not appreciated the effect of the order passed by the Supreme Court on appeal in the case of Maruti Suzuki. The order passed by the Supreme Court a short one, reads:

> "Leave granted.
>
> By consent, the matter is taken up for hearing.
>
> In this case, the High Court has remitted the matter to the Transfer Pricing Officer ['TPO', for short] with liberty to issue fresh show-cause notice. The High Court has further directed the TPO to decide the matter in accordance with law. Further, on going through the impugned judgement of the High Court dated 1st July, 2010, we find that the High Court has not merely set aside the original show-cause notice but it has made certain observations on the merits of the case and has given directions to the TPO, which virtually concludes the matter. In the circumstances, on that limited issue, we hereby direct the TPO, who, in the meantime, has already issued a show-cause notice on 16th September, 2010, to proceed with the matter in accordance with law uninfluenced by the observations/directions given by the High Court in the impugned judgement dated 1st July, 2010.
>
> The TPO will decide this matter on or before 31st December, 2010.
>
> The civil appeal is, accordingly, disposed of with no order as to costs."

156. A Division Bench of Delhi High Court in the writ petition challenging the Transfer Pricing Order had dealt with transfer pricing issues and had enrolled and culled out legal ratios and principles. Directions were issued. At the same time, an order of remand to the TPO to compute the arm's

length price on the basis of said principles was passed. It would not be correct to hold that the Supreme Court had accepted and had given seal of approval and not interfered with the principles/ratio enunciated in the judgment by the Delhi High Court. The Supreme Court as is lucid did not want to examine the principles or ratio as enunciated and express their opinion on merits, though the directions issued by the High Court, it was observed, "conclude the matter". The Supreme Court perceived and accepted that the 'issue' of arm's length price should be re-examined by the TPO without being curtailed or restrained by the legal principles/ratio delineated. As the Supreme Court itself was not examining the principles/ratio on merits, it did not pass any order in favour or against the assessee or the Revenue. Accordingly, the aforesaid observations. The effect thereof was that the judgment of the Delhi High Court would not operate as *res judicata* between the parties and merits, if required, would be examined and gone into in the appellate proceedings. The majority judgment has incorrectly inferred that the legal principles and directions issued by the Delhi High Court would continue to be binding *decidendi* and had attained finality, *viz*. the tax authorities and the Tribunal. It is not so indicated. If the legal principles/ratio was not binding on the writ petitioner, i.e. the assessed in the said case, it would be *malapropos* and inappropriate to treat the directions as binding ratio, in respect of third parties. Therefore, we have not treated the decision of the Delhi High Court in the case of ***Maruti Suzuki Ltd.*** (supra) as a binding precedent. Importantly, the Revenue has relied upon the final conclusions as recorded and the assessed have relied upon the earlier portions of the judgment. We have considered the reasoning given in the aforesaid decision and have reached our own conclusion.

N. Resale Price Method

157. We begin by reproducing Rule 10B(1)(b) of the Rules:-

> **"Determination of arm's length price under section 92C.**
>
> **10B.** (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction *or a specified domestic transaction* shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—
>
> (a) xxx
>
> (b) Resale Price Method, by which,—
>
> (i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;
>
> (ii) such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;
>
> (iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;
>
> (iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction *or the specified domestic transaction* and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;
>
> (v) the adjusted price arrived at under sub-clause (*iv*) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;
>
> xxx"

158. RP Method as an axiom, the United Nations' Manual exposits:

> "6.2.6.3. Consequently, under the RPM the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1) can be described in the following formula:
>
> TP = RSP x (1-GPM), where:
>
> - TP = the *Transfer Price* of a product sold between a sales company and a related company;

> - RSP = the *Resale Price* at which a product is sold by a sales company to unrelated customers; and
> - GPM = the *Gross Profit Margin* that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold."

159. RP Method, i.e. the Resale Price Method computes the arm's length price by ascertaining or identifying the price at which the product is resold by the AE to an independent enterprise. From this price, the amount of gross profit margin accruing to the AE or to an unrelated enterprise, i.e. comparable, is subtracted. The comparable should be engaged in purchase and re-sale of same or similar property and/or obtaining or providing similar services. From this amount, the expenses incurred by the AE in connection with the purchase of property or obtaining of services are further subtracted. At the fourth stage, adjustments are made taking into account the functional and other differences, including the accountancy practices, if any, between the tested international transaction and the comparable uncontrolled transactions to the extent they would materially affect the gross profit margins in the open market. The price computed after the two reductions and after the adjustment on account of the functional and other differences, determines the arm's length price of the purchased property or services obtained by the assessed from the AE.

160. RP Method postulates reverse calculation, as it first requires identification and ascertainment of resale price, then reductions and adjustment. It hypothesises ascertainment of normal gross profit margins of comparables including, if required, adjustment on account of functional and other differences with comparables. Uncontrolled transaction is comparable with the controlled transaction for the purpose of RP Method, only if two conditions are satisfied: that there is no difference between the functions, which would materially affect the normal gross profit margins in the open market; and reasonably accurate adjustments can be made to eliminate material effect of such differences. RP

Method may require fewer adjustments on account of product differences comparison to the CUP Method, i.e. Comparable Uncontrolled Price Method because minor product differences are less likely to have material effect on the profit margins as they do on the price. Compensation for performing similar functions tends to equalise across different activities, whereas in case of products, the equalisation is normally possible to the extent that products are substitute for each other. Nevertheless, similarity of the property as transferred in the controlled transaction for closer comparability of products/services would produce more accurate results. Sometimes, RP Method is adopted as more accurate or best method where controlled and uncontrolled transactions are comparable in all characteristic, other than the product itself. In some cases, it may be a preferable and more reliable method in comparison to the CUP Method or CP Method. However, RP Method has its weaknesses. It 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. In the OECD Commentary on Transfer Pricing Guidelines it has been observed:

> " … Another example where the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.
>
> 2.30 A resale price margin is more accurate where it is realised within a short time of the reseller's purchase of the goods. The more time that elapses between the original purchase and resale, the more likely it is that other factors — changes in the market; in rates of exchange; in costs etc. — will need to be taken into account in any comparison.
>
> 2.31 It should be expected that the amount of the resale price margin be influenced by the level of activities performed by the reseller. This level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, and other connected services. If the reseller in the controlled transaction does not carry on a substantial commercial activity, but only transfers the goods to a third party, the

> resale price margin could, in light of the functions performed, be a small one. The resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product. However, the level of activity performed by the reseller, whether minimal or substantial, would need to be well supported by relevant evidence. This would include justification for marketing expenditures that might be considered unreasonably high; for example, when part or most of the promotional expenditure was clearly incurred as a service performed in favour of the legal owner of the trademark. In such\a case the Cost Plus method may well supplement the RP Method."

161. The United Nations' Manual on RP Method highlights that this method is based upon arm's length gross profits, rather than directly determining arm's length prices. As compared to CUP Method, RP Method requires less direct transactional (product) comparability than CUP Method. However, there must be functional comparability. A similar level of compensation is expected for performing similar functions across different activities. This uniformity and similitude is necessary because similar gross profits are being compared. If there are material differences that reflect in the gross profit margins between the controlled and uncontrolled transaction, adjustments should be possible on account of such differences. Functions performed can be simple and cover a limited field of sales, general or administrative expenses; to more complex one, adding substantially to the gross profit margins. The latter may happen if the reseller adds substantially to the value of the product by assisting considerably in creation and maintenance of intangible products or where the goods are further processed into a more valuable or complicated product. Referring to the weaknesses of the said method, the commentary states:-

> "The method can be used without forcing distributors to inappropriately "make profits". The distributor earns an arm's length gross profit margin, however, but could have operating losses due, for example, to high selling expenses caused by business strategies such as a market penetration strategy. By comparison, the application of the Transactional Net Margin Method, which analyses a financial ratio based on operating profits, will generally result in an arm's length range of positive operating profits. The tested party in the analysis would then probably also earn a positive operating profit within the range. However, the Resale Price Method does not necessarily result in positive operating profits to be earned by the tested party.

xxx

> **6.2.11. When to Use the Resale Price Method**
>
> **6.2.11.1.** In a typical inter-company transaction involving a "fully-fledged" manufacturer (i.e. as compared, for example, with a limited risk company or contract manufacturer) owning valuable patents or other intangible properties and affiliated sales companies which purchase and resell the products to unrelated customers, the Resale Price Method is an appropriate method to use if:
>
> \> The CUP Method is not applicable;
> \> The sales companies do not own valuable intangible properties; and
> \> Reliable comparisons can be made on COGS (cost of goods sold)."

162. In the case of Reebok India Co. Ltd., the assessee has applied RS Method using internal comparable. Contrary to the general rule, the internal comparable possibly may not be appropriate when the assessed has incurred considerable (not necessarily extra-ordinary or non-routine) AMP expenses. The reason is obvious; there is no comparability analysis possible. In such cases, it is not possible to examine and compare the functional comparability between the controlled tested transaction and uncontrolled internal party transaction on account of AMP expenses. Internal comparable would not account for the credible gross profit rate, which an AE should be ensured when it incurs AMP expenses. Functionally the comparable is merely a manufacturer and thus, the said function is compared. AMP expenses do not get factored and compared. As an abundant caution, we would still add that where adjustments clause (iv) can give reliable and accurate results, internal comparables could still be applied. This would likely happen, when AMP expenses are insignificant in quantum.

163. Thus, in such cases, external comparables where said parties are performing similar functions including AMP expenses would give more accurate and precise results.

164. However, it would be wrong to assert and accept that gross profit margi would not inevitably include cost of AMP expenses. The gross profit margins could remunerate an AE performing marketing and selling function. This has to be tested and examined without any assumption against the assessed. A finding on the said aspect would require detailed verification and ascertainment.

165. An external comparable should perform similar AMP functions. Similarly the comparable should not be the legal owner of the brand name, trade mark etc. In case a comparable does not perform AMP functions in the marketing operations, a function which is performed by the tested party, the comparable may have to be discarded. Comparable analysis of the tested party and the comparable would include reference to AMP expenses. In case of a mismatch, adjustment could be made when the result would be reliable and accurate. Otherwise, RP Method should not be adopted. If on comparable analysis, including AMP expenses, gross profit margins match or are within the specified range, no transfer pricing adjustment is required. In such cases, the gross profit margin would include the margin or compensation for the AMP expenses incurred. Routine or non-routine AMP expenses would not materially and substantially affect the gross profit margins when the tested party and the comparable undertake similar AMP functions.

166. On behalf of the assessee, it was initially argued that the TPO cannot account for or treat AMP as a function. This argument on behalf of the assessee is flawed and fallacious for several reasons. There are inherent flaws in the said argument. Moreover, the contention of the assessed in these appeals would mandate rejection of the RP Method, as an appropriate or most appropriate method. Comparison or comparative analysis is undertaken at stage (ii). Adjustments are permissible and undertaken at stage (iv). Under clause (iii), i.e. at stage (iii), from the price ascertained at stage (ii), expenses incurred by the

enterprise in connection with the purchase of property or obtaining of services reduced. Under clause (iv), adjustments have to be made on account of functional difference which would include assets used and risk assumed. It is at stage (iv) of the RP Method that the Assessing Officer/TPO can make adjustments if he finds that an assessee has incurred substantial AMP expenses in comparison to the comparables. Once adjustments are made, then the appropriate arm's length price can be determined. In case, it is not possible to make adjustments, then RP Method may not be the most appropriate and best method to be adopted.

167. Before us, the Revenue has not pleaded or submitted that the RP Method should not have been adopted. The TPO and the Assessing Officer did not reject the RP Method adopted by the assessee. The assessed submit that the Revenue accepts functional parity and in fact, without adjustment. Contra, Revenue would argue that the Assessing Officer/TPO and the Tribunal have adopted and applied the CUP Method for determining arm's length price of AMP expenses. We do not pronounce a firm and final opinion on the said lis as it should be at first examined by the Tribunal.

168. The Tribunal has upheld adoption of CP Method after applying 'bright line test' in the case of Reebok India Co. Ltd. and Canon India Pvt. Ltd. The 'bright line test' adopted to demarcate the routine and non-routine AMP expenditure is predicated on selection of a domestic distributor and marketing company that does not own intangible brand rights. Contract value would be treated as NIL. In terms of our finding recorded above, the said finding would not be correct. The approach and procedure for ascertaining /determining arm's length price under the RP Method is different. For this reason, and other grounds recorded, we have passed an order of remit to the Tribunal for examination of the factual matrix.

O. Cost Plus Method

169. CP Method as stipulated in Rule 10B (1)(c) is as under:

> **"10B.** (1) For the purposes of sub-section (2) of section 92C, the arms length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :
>
> xxx
>
> (c) cost plus method, by which,
>
> (i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
>
> (ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
>
> (iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
>
> (iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);
>
> (v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;"

170. United Nations' Manual in arithmetic terms has elucidated CP Method in the following manner:

> "The formula for the transfer price in inter-company transactions of products is as follows: TP = COGS x (1 + cost plus markup), where:
>
> > TP = the *Transfer Price* of a product sold between a manufacturing company and a related company;
>
> > COGS = the C*ost of Goods Sold* to the manufacturing company; and

> > Cost plus mark-up = gross profit mark-up defined as the ratio of gross profit to cost of goods sold. Gross profit is defined as sales minus cost of goods sold."

The said method is strictly applied to manufacturing or assembling activities or relatively simple service providers. Like RP Method, CP Method is a gross margin method as it attempts to derive the arm's length price on a mark-up of cost of goods or services provided.

171. Determination of cost or expense can cause difficulties in applying CP Method. Careful consideration should be given, 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. The gross profit of the comparable is applied and accepted, when there is no difference between the AMP and other functions being compared that would materially affect the gross profit mark up or when reasonably accurate adjustments can be performed. Thus, CP Method requires functional comparability. This comparability analysis would necessarily imply that the comparable must and should be performing similar functions, including the nature of costs and expenses incurred. If the discounts/incentives and for that matter entire distribution and marketing expenses are treated as costs, functional and comparable analysis comparison should be similar. Thus, the entire cost, i.e. marketing expense or distribution and marketing expense, can be made subject matter and included in 'cost', for determining arm's length price by applying CP Method.

172. The United Nations' Manual discourages application of CP Method in transactions involving full-fledged manufacturer who owns valuable product intangibles i.e. a manufacturer who has incurred considerable cost on Research

& Development, patent, technology etc. for the reason that it is difficult locate a similar independent manufacturer owning comparable. There is no finding or examination on this aspect by the Tribunal. We caution, the reference above is to valuable product intangibles and not marketing intangibles. The assessed rely upon AEs valuable product intangibles. The issue can be answered after ascertaining facts and whether similar comparables are available. We have not pronounced a firm opinion. Obviously, the aforesaid caveat would not arise if and when, AMP as a transaction is separately benchmarked and tested.

173. This 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. Allocation of price or compensation paid would be a contentious question and apportionment must be justified and fair. 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.

174. Costs or expenses incurred for services provided or in respect of property transferred, when made subject matter of arm's length price by applying CP Method, cannot be again factored or included as a part of inter-connected international transaction and subjected to arm's length pricing. This situation would possibly result in over, if not double taxation, contrary to the object and purpose of arm's length pricing, which is to tax the real income after correcting the negative impact, if any, of the controlled conditions. Therefore, if entire marketing and distribution expenses, or marketing or AMP expenses are bench marked under CP Method, then it would be injudicious and irrational to apply any other method to compute the arm's length price of a larger composite

international transaction, of which the said costs and expenses form only a pa Logically, if the costs or expenses as a function are excluded or included in the cost while computing the arm's length price under the CP Method, the gross profit as a result of such transaction would be lower or higher. This situation would be different from subjecting the same international transaction to arm's length pricing by two different methods, which is permissible, in the manner stipulated in the first Proviso to Section 92C of the Act.

P. Direct Marketing Expenses

175. The argument of the Revenue on direct marketing expenses is as under:-

> "1. Special Bench of the ITAT has decided in the case of LG Electronics India Pvt. Ltd. that selling expenses such as discounts and incentives/pricing adjustments should not be considered as part of AMP expenses. The argument against their inclusion in AMP expenses is that these expenses are nothing but a reduction in the price of product and do not create any marketing intangible.
>
> 2. The objective of the AMP activities is not to merely advertise the brand to the ultimate customers. It is also to make the brand popular to the dealers who will eventually push the 'XX' brand over other brands in the market. Only when a reasonable amount of brand loyalty is built up among the dealers, the entire circle of AMP activities will be complete. The discounts and incentives that the assessing is passing on to the dealers is the tool that it employs to create this brand loyalty among them. Once they are convinced that this company is passing on a greater benefit to them only then will they push the products of this company towards the ultimate customer, over other brands.
>
> 3. The dealer incentives and other selling expenses form part of the market penetration strategy of the assessee. Incentives given to dealers help the assessee in enhancing the market share of the assessee and create loyalty for the brand of the AE among the dealers. Since, these dealer incentives lead to creation of marketing intangible, the same need to be also considered as part of AMP expenses.
>
> 4. In this connection, it may be mentioned that normal discounts are factored into the sales that are taken for calculation of the AMP expenses.
>
> 5. As regards the other selling expenses, over and above the normal discounts, if they are being incurred at the behest of the AE, as part of the

> market penetration strategy, they will qualify as AMP expenses. These expenses form part of the brand building strategy that is being executed by the Indian subsidiary on behalf of the AE."

176. The aforesaid argument, when AMP expenses are segregated from the composite transaction including distribution and marketing function, is flawed and has to be rejected. The respondent-assessees are engaged in distribution and marketing of consumer goods. Distribution and marketing exercise in case of tangibles requires transfer/sale of goods to third parties, be it sub-distributors or retailers. The said transaction is in the nature of sale of goods for consideration. 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. These reduce the net profit margin. It would lead to abnormal financial results defying accountancy practices and commercial and business sense. The expenses being in the nature of selling expenses have an immediate connect with price/consideration payable for the goods sold. They are not incurred for publicity or advertisement. Direct marketing and sale related expenses or discounts/concessions would not form part of the AMP expenses.

177. In the present case, neither the assessed nor the Assessing Officer/TPO has adopted CUP Method for determination of arm's length price. TNM Method or RP Method has been adopted and accepted as the most appropriate method. TNM Method, as noticed above, obligates analysis of profit and loss account and the test is benchmarking of operating profits with the relevant PLI

and comparison with reference to the comparable. Discount and incentiv offered, reduce the operating profits and, therefore, the benchmarking exercise with comparables, reflects and accounts for the same. We have examined the impact and consequences of applying CP Method, by factoring and treating AMP expenses and trade discounts and incentives as an independent international transaction, when we continue to treat the said expenses as a component of a packaged international transaction, which is separately benchmarked. This would not lead us to accurate and reliable results. There is need and requirement to check over or double taxation.

178. The prime lending rate cannot be the basis for computing mark-up under Rule 10B(1)(c) of the Rules, 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. The Revenue's stand in some cases applying the prime lending rate fixed by the Reserve Bank of India with a further mark-up, is mistaken and unfounded. Interest rate mark-up would apply to international transactions granting/ availing loans, advances, etc.

Q. **Arm's Length Price of royalty paid by Reebok India Company Ltd (ITA No.213/2014**

179. We now proceed to examine and answer, the question raised by the Revenue in the appeal filed against Reebok India Company Ltd.

180. Royalty of Rs.15,28,77,527/- paid to Reebok International Ltd., U.K., was benchmarked by the assessed using CUP Method as the most appropriate method. Royalty paid by Sierra Industrial Enterprises Pvt. Ltd. to Nike

International Ltd. USA @ 5% was taken as a valid comparable. In addition, t assessed relied upon Foreign Exchange Management (Current Account Transactions) Rules, 2000 authorising remission of royalty of upto 5% on domestic sales and upto 8% on exports under the automatic route to foreign technical collaborators. The TPO rejecting the claim, observed that the assessed had not established cost-benefit analysis for payment of royalty. No such exercise had been carried out. The TPO referred to technology licence agreement dated 1st October, 2002 between the assessee and Reebok International Ltd., U.K. for providing data, documentation, drawings and specifications relating to inventions, designs, formulae, processes and similar properties, referred to as know-how and the non-exclusive, non-transferable right granted to utilize the technology to manufacture and distribute Reebok products in India. He referred to the profitability data of the assessed and observed that the technology and payment of royalty was not reflected in the profit margins or commensurate benefit. He, therefore, came to the conclusion that no independent enterprise would make payments for royalty which were not contributing to its profitability. The profitability data relied upon by the Assessing Officer reads as under:

"

F.Ys.	2005-06	2006-07	2007-08
Sales (WSP)	252.5	366.2	451.23
Royalty	6.82	9.62	15.29
Net Profit	17.76	32.81	33.34
Net Profit/Sales	7.03%	8.96%	7.4%

"

181. The TPO accordingly determined the arm's length price of royalty as 'NIL' in place on Rs.15,28,77,527/- under CUP Method. The DRP affirmed the action of the TPO and consequently, an assessment order holding that the arm's length price of the royalty was 'NIL', in place of controlled transaction value of Rs.15,28,77,527/-, was passed.

182. The Tribunal in the impugned order while allowing the appeal, h referred to the technology and know-how furnished in the form of 'PUMP' technology, 'DMX' technology and '3D Ultralite' technology. New products were designed and developed after research and development at the Research & Development and Product Creation Centre in Canton, USA. These patented technologies were used in local development and manufacturing process for footwear and apparels. The entire business of the assessee in India was dependent upon the patented technology provided by the AE which could not have been used without licence/permission. Total revenue of the assessed had increased to Rs.451.97 crores from Rs.360.95 crores in the previous year, registering a growth of 25.21%. The technology was required to survive and grow in a competitive industry where continuous innovation was a pre-requisite. The Tribunal observed that payment of royalty was treated as a bona fide expenditure in the earlier years and it was an undisputed position that know-how or technical information had been provided under the licence agreement.

183. On the question whether the royalty should have been paid or not, we are in agreement with the finding of the Tribunal that question of payment of royalty cannot be determined on the basis of profitability or earnings of the assessed, once it is accepted that know-how and technical information was provided. It is not alleged or the case of the Revenue that the technology or know-how was hopeless and useless. The finding of the Assessing Officer/TPO, that the assessee had not derived any commercial benefit as technology and know-how had not resulted in any substantial profit increase, has been rightly rejected as totally unsustainable. Profitability of the assessed could have been lower or varied due to various reasons and lower profitability in one or more years cannot lead to the conclusion that no benefits were derived or technology was unproductive. The justification given by the assessee for

lower profits on account of bad debts, high rent, increase in legal cost sta highlighted and accepted by the Tribunal.

184. Transfer pricing provisions, as noted above, recognise separate entity principle. Therefore, as a sequitur, it follows that the AE is a separate entity and when it avails and secures advantage of technical know-how, it should pay arm’s length price for the right to use. The arm’s length price would be the fair market price of the technical know-how, which is licensed.

185. Royalty payable for availing the right to use would depend upon corresponding price, which would have been paid by an independent or unrelated enterprise. This is judged by applying comparables. TPO has not rejected the quantum of royalty on the said principle. The reasoning given by the TPO is not only erroneous for the reasons stated above, but is also contrary to the Rules. Depending upon the method selected, net profit or gross profit of the assessed has to be compared with profit margins of related enterprise. The formula prescribed under the Rules does not accept the ratiocination adopted and applied by the TPO.

186. A similar controversy had arisen before the Delhi High Court in ***EKL Appliances Limited,*** (supra). The assessed in the said case was incurring losses and on this pretext, the TPO had disallowed the entire brand fee or royalty. The Tribunal disagreed with the Revenue. The appeal filed by the Revenue was dismissed stating that the considerations relied by the TPO were irrelevant considerations for the purpose of Rule 10B. The Division Bench of this Court rejected the argument that financial health of the assessee alone would determine whether or not the transfer price paid was appropriate and the fair market value. This would be an extraneous consideration for disallowing the whole expenditure, when technology was required and provided. Opinion of

the assessed matters. The transfer pricing regulations permit examination of t international transaction and suitable adjustments. It would be a different matter if it is established that an independent entity, in the given prevailing circumstances, would not have entered into the said transaction with the AE. This is not the case set up by the Revenue. The assessed in the present case has made profits.

187. The Tribunal in the impugned order, therefore, had rightly applied the test of commercial expediency and has recorded that the assessed was free to conduct business in the manner it deems fit. We hasten to add that two exceptions have been carved out in the case of ***EKL Appliances Limited*** (supra), but the exceptions have not been invoked, nor are the conditions satisfied.

188. Importantly, the assessee had benchmarked royalty with instances of royalty paid by third party licensee/distributors and had relied upon the three agreements, which were quoted as comparables. As per the comparables, the royalty paid was between 10-12% and they are:-

> “(ii) Agreement between Double D'Import S.A.R.I (France) with Adidas International for payment of royalty @ 12%.
>
> (iii) Agreement of Sportsvision with Adidas international for payment of royalty @ 10%.
>
> (iv) Agreement of Molten Corporation Japan with Adidas International Marketing BV for payment of royalty @ 12%.”

189. The Tribunal has noted with disapproval the observation of the TPO that comparable instances were not given, observing that this was factually incorrect.

190. However, do not agree with the finding recorded by the Tribunal that as the Government of India had permitted remission of royalty through automatic route, the royalty paid can be *per se* or conclusively treated as the arm's length

price. Applicable rules authorise remission of royalty upto a particu percentage under automatic route to the foreign collaborators. Authorising remission through automatic route upto a particular percentage, does not reflect examination of arm's length principle. It would be incorrect to read into the general authorisation under the Foreign Exchange Management Act and Rules, an implied adjudication order on the question of quantum or arm's length price. When specific permission is granted, the issue may acquire a different dimension. We do not express any opinion, when specific permission is relied upon.

191. The fact that royalty has been paid would be a relevant consideration and factum, when we consider arm's length price of the international transaction of distribution and marketing. Tax treatment of royalty payments being different, the royalty transaction, therefore, may be benchmarked separately. However, payment of royalty even if justified and appropriate on applying arm's length principle, can be a relevant factor when the question of compensation of the domestic AE for undertaking distribution and marketing functions arises for consideration.

R. Question of Remand

192. During the course of oral arguments, the assessed had filed tabulated computations to establish and show the inaccuracies, unsavoury and severe, if not bitter, consequences of the adjustments made by the TPO. For example, in the case of ***Canon India Private Limited***, the reasoning of the TPO was challenged on the ground of absurdity and perversion, alleging that Indian turnover was a miniscule percentage of the global turnover and, thus, profit shifting by attributing higher or greater profits to Canon Inc. Japan, etc. was

fallacious. Revenue has contested some of the submissions by filing their ov charts/tables.

193. We would not like to go into several factual aspects for the first time, for the factual matrix has not been examined and ascertained by the Tribunal. Moreover, in terms with our legal finding, factual findings will have to be examined. An order of remand for *de novo* consideration to the Tribunal 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, at the first instance, would try and dispose of the appeals, rather than passing an order of remand to the Assessing Officer/TPO. The 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 arm's length price.

Answers to Substantial Questions of Law

194. In view of the aforesaid discussion, substantial questions of law in the appeals filed by the assessee are answered as under:

> "Q.1. Whether the additions suggested by the Transfer Pricing Officer on account of Advertising/Marketing and Promotion Expenses ('AMP Expenses' for short) was beyond jurisdiction and bad in law as no specific reference was made by the Assessing Officer, having regard to retrospective amendment to Section 92CA of the Income Tax Act, 1961 by Finance Act, 2012."

In terms of and subject to discussion under the heading C, paragraph Nos.41 50, the substantial question of law No.1 is answered in favour of the Revenue and against the assessee.

> "Q.2. Whether AMP Expenses incurred by the assessee in India can be treated and categorized as an international transaction under Section 92B of the Income Tax Act, 1961."

In terms of and subject to discussion under the heading C, paragraph Nos.51 to 57, the substantial question of law No.2 is answered in favour of the Revenue and against the assessee.

> "Q.3. Whether under Chapter X of the Income Tax Act, 1961, a transfer pricing adjustment can be made by the Transfer Pricing Officer/ Assessing Officer in respect of expenditure treated as AMP Expenses and if so in which circumstances?
>
> Q.4. If answer to question Nos.2 and 3 is in favour of the Revenue, whether the Income Tax Appellate Tribunal was right in holding that transfer pricing adjustment in respect of AMP Expenses should be computed by applying Cost Plus Method.
>
> Q.5. Whether the Income Tax Appellate Tribunal was right in directing that fresh bench marking/comparability analysis should be undertaken by the Transfer Pricing Officer by applying the parameters specified in paragraph 17.4 of the order dated 23.01.2013 passed by the Special Bench in the case of LG Electronics India (P) Ltd.?."

In terms of and subject to discussion under the headings D to P, we hold that the legal ratio accepted and applied by the Tribunal relying upon the majority decision in ***L.G. Electronics India Pvt. Ltd*** (supra) is erroneous and unacceptable. For reasons set out above, we have passed an order of remand to the Tribunal to examine and ascertain facts and apply the ratio enunciated in this decision. For the purpose of clarity, we would like to enlist our findings:-

(i) In case of a distributor and marketing AE, the first step in transfer pricing is to ascertain and conduct detailed functional analysis, which would include AMP function/expenses.

(ii) The second step mandates ascertainment of comparables or comparable analysis. This would have reference to the method adopted which matches the functions and obligations performed by t tested party including AMP expenses.

(iii) A comparable is acceptable, if based upon comparison of conditions a controlled transaction is similar with the conditions in the transactions between independent enterprises. In other words, the economically relevant characteristics of the two transactions being compared must be sufficiently comparable. This entails and implies that difference, if any, between controlled and uncontrolled transaction, should not materially affect the conditions being examined given the methodology being adopted for determining the price or the margin. When this is not possible, it should be ascertained whether reasonably accurate adjustments can be made to eliminate the effect of such differences on the price or margin. Thus, identification of the potential comparables is the key to the transfer pricing analysis. As a sequitur, it follows that the choice of the most appropriate method would be dependent upon availability of potential comparable keeping in mind the comparability analysis including befitting adjustments which may be required. As the degree of the comparability increases, extent of potential differences which would render the analysis inaccurate necessarily decreases.

(iv) The assessed, i.e. the domestic AE must be compensated for the AMP expenses by the foreign AE. Such compensation may be included or subsumed in low purchase price or by not charging or charging lower royalty. Direct compensation can also be paid. The method selected and comparability analysis should be appropriated and reliable so as to include the AMP functions and costs.

(v) Where the Assessing Officer/TPO accepts the comparables adopted by the assessed, with or without making adjustments, as a bundled transaction, it would be illogical and improper to treat AMP expenses as a separate international transaction, for the simple reason that if the functions performed by the tested parties and the comparables match, with or without adjustments, AMP expenses are duly accounted for. It would be incongruous to accept the comparables and determine or accept the transfer price and still segregate AMP expenses as an international transaction.

(vi) The Assessing Officer/TPO can reject a method selected by the assessed for several reasons including want of reliability in the factual matrix or lack / non-availability of comparables. (see Section 92C(3) of the Act).

(vii) When the Assessing Officer/TPO rejects the method adopted by the assessed, he is entitled to select the most appropriate method, and undertake comparability analysis. Selection of the method and comparables should be as per the command and directive of the Act and Rules and justified by giving reasons.

(viii) Distribution and marketing are inter-connected and intertwined functions. Bunching of inter-connected and continuous transactions is permissible, provided the said transactions can be evaluated and adequately compared on aggregate basis. This would depend on the method adopted and comparability analysis and the most reliable means of determining arm's length price.

(ix) To assert and profess that brand building as equivalent or substantial attribute of advertisement and sale promotion would be largely incorrect. It represents a coordinated synergetic impact created by assortment largely representing reputation and quality. “Brand” has reference to a name, trademark or trade name and like ‘goodwill’ is a value of attraction to customers arising from name and a reputation for skill, integrity, efficient business management or efficient service. Brand creation and value, therefore, depends upon a great number of facts relevant for a particular business. It reflects the reputation which the proprietor of the brand has gathered over a passage or period of time in the form of widespread popularity and universal approval and acceptance in the eyes of the customer. Brand value depends upon the nature and quality of goods and services sold or dealt with. Quality control being the most important element, which can mar or enhance the value.

(x) Parameters specified in paragraph 17.4 of the order dated 23rd January, 2013 in the case of ***L.G. Electronics India Pvt Ltd*** (supra) are not binding on the assessed or the Revenue. The ‘bright line test’ has no statutory mandate and a broad-brush approach is not mandated or prescribed. We disagree with the Revenue and do not accept the overbearing and orotund submission that the exercise to separate ‘routine’ and ‘non-routine’ AMP or brand building exercise by applying ‘bright line test’ of non-comparables should be sanctioned and in all cases, costs or compensation paid for AMP expenses would be ‘NIL’, or at best would mean the amount or compensation expressly paid for AMP expenses. It would be conspicuously wrong and incorrect to treat the segregated transactional value as ‘NIL’ when in fact the two AEs had treated the international transactions as a package or a single one and contribution is attributed to the aggregate package. Unhesitatingly, we add that in a specific case this criter and even zero attribution could be possible, but facts should so reveal and require. To this extent, we would disagree with the majority decision in ***L.G. Electronics India Pvt. Ltd.*** (supra). This would be necessary when the arm's length price of the controlled transaction cannot be adequately or reliably determined without segmentation of AMP expenses.

(xi) The Assessing Officer/TPO for good and sufficient reasons can de-bundle interconnected transactions, i.e. segregate distribution, marketing or AMP transactions. This may be necessary when bundled transactions cannot be adequately compared on aggregate basis.

(xii) When segmentation or segregation of a bundled transaction is required, the question of set off and apportionment must be examined realistically and with a pragmatic approach. Transfer pricing is an income allocating exercise to prevent artificial shifting of net incomes of controlled taxpayers and to place them on parity with uncontrolled, unrelated taxpayers. The exercise undertaken should not result in over or double taxation. Thus, the Assessing Officer/TPO can segregate AMP expenses as an independent international transaction, but only after elucidating grounds and reasons for not accepting the bunching adopted by the assessed, and examining and giving benefit of set off. Section 92(3) does not bar or prohibit set off.

(xiii) CP Method is a recognised and accepted method under Indian transfer pricing regulation. It can be applied by the Assessing Officer/TPO in case AMP expenses are treated as a separate international transaction, provided CP Method is the most appropriate and reliable method.

Adoption of CP Method and computation of cost and gross pro margin comparable must be justified.

(xiv) The object and purpose of Transfer Pricing adjustment is to ensure that the controlled taxpayers are given tax parity with uncontrolled taxpayers by determining their true taxable income. Costs or expenses incurred for services provided or in respect of property transferred, when made subject matter of arm's length price by applying CP Method, cannot be again factored or included as a part of inter-connected international transaction and subjected to arm's length pricing.

195. The above noted pointers have to be read along with our discussion under the headings D to P. In case of any doubt, debate or purported conflict, it would be preferable to rely upon detailed elucidation made under the headings, D to P.

196. Common questions raised by the Revenue in their appeals:-

> "1. Whether the Income Tax Appellate Tribunal was right in distinguishing and directing that selling expenses in the nature of trade/volume discounts, rebates and commission paid to retailers/dealers etc. cannot be included in the AMP Expenses?"

In terms of and subject to our discussion under the headings O and P, the substantial question of law has to be answered against the Revenue and in favour of the assessee.

Substantial question of law in *CIT versus Reebok*, ITA 213/2014

197. The following substantial question of law is raised:

> "Whether Income Tax Appellate Tribunal was right in setting aside/deleting transfer pricing adjustment made on account of payment of royalty to an associated enterprise?"

In view the discussion under the heading Q, the substantial question of law answered against the Revenue and in favour of the assessee.

198. Lastly, a word of caution is necessary that our findings or ratio should not be construed as an attempt to impart a talismanic precision to this complex issue which would to a large extent depend on the factual matrix of a given case. Disputes of such nature, highlight importance of 'safe harbour rules', for they instil certainty and curtail litigation.

199. We must, at the conclusion, commend and acknowledge the contemplative and epiphanic arguments put forth by the learned counsels of the assessed and the Revenue. We had the benefit of the meticulous and intensive research and study by the counsel for the assessed along with their associates, and the Revenue, who were ably assisted by a team of officers.

200. The appeals are accordingly disposed of. No costs.

201. In order to cut short delay, the parties are directed to appear before the Tribunal on 20th April, 2015, when a date of hearing will be fixed.

(SANJIV KHANNA)
Judge

(V. KAMESWAR RAO)
Judge

March 16th, 2015
kkb/vkr/na