

IN THE INCOME TAX APPELLATE TRIBUNAL, DELHI 'I-2' BENCH,
NEW DELHI

BEFORE SHRI N.K. BILLAIYA, ACCOUNTANT MEMBER, AND
SHRI SUDHANSHU SRIVASTAVA, JUDICIAL MEMBER

ITA No. 7574/DEL/2017
[A.Y 2013-14]

M/s Sennheiser Electronics India Ltd
102-A, First Floor, Time Tower
M.G. Road, Gurgaon, Haryana

Vs.

The A.C.I.T
Circle - 4(1)
Gurgaon

PAN : AAKCS 4629 Q

[Appellant]

[Respondent]

Date of Hearing : **10.09.2018**
Date of Pronouncement : **19.09.2018**

Assessee by : Shri Alok Vasant, Adv

Revenue by : Shri H.K. Choudhary, CIT-DR
Ms. Anchal Khandelwal, Sr.DR

ORDER

PER N.K. BILLAIYA, ACCOUNTANT MEMBER,

With this appeal, the assessee has challenged the correctness of the order dated 29.11.2011 framed u/s 143(3) r.w.s 144C of the Income-tax Act, 1961 [hereinafter referred to as 'the Act'].

2. The assessee is aggrieved by the addition to the total income of the assessee using Bright Line Test on protective basis amounting to Rs. 4,08,18,553/- and is further aggrieved by the addition of Rs. 5,95,56,701/- using cost plus method on substantive basis on account of the alleged difference in arm's length price [ALP] of the international transaction of advertisement, marketing and promotion [AMP] expenses.

3. Briefly stated, the facts of the case are that the appellant company was incorporated on 11.01.2007 as a subsidiary of Sennheiser Global Operations GmbH. The appellant company is primarily engaged in the business of sales and distribution of headphones, microphones, receivers, monitoring systems, tour guide systems and aviation headsets. It imports goods from Sennheiser Group Companies for reselling through its distributors in India. The appellant company distributes all brands of the Sennheiser group and has service centres located in Haryana, Mumbai and Bangalore and also service products within and outside warranty. The appellant also import spares from Sennheiser group Companies.

4. During the course of scrutiny assessment proceedings, the case was referred to the TPO who framed order dated 26.10.2016 u/s 92CA of the Act and determined adjustment of Rs. 4,33,12,598/- on account of AMP adjustment. Pursuant to the order of the TPO, a draft assessment order was passed on 19.12.2016 wherein the total income was assessed at Rs. 6,13,75,390/- after making addition of Rs. 4,33,12,598/- on account of T.P. adjustment/addition.

5. Aggrieved by the proposed addition, the assessee company raised objections against the draft assessment order before the DRP and the DRP passed its order on 28.09.2017. Pursuant to the directions of the DRP, the TPO finally framed the order and the same reads as under:

"The Hon'ble DRP has directed to apply bright line method for computation of ALP of expenses. Hence, the working of adjustment using bright line method is as under:

3.1 The assessee has incurred Rs. 3,75,58,618/- towards AMP expenses during the year under consideration. During the course of proceedings for AY 2012-13, this office had taken a stand that bright line test should be applied and any AMP expenditure incurred by the taxpayer in excess of the expenditure incurred by the comparables should be considered as the expenditure incurred

by the taxpayer for the benefit of the parent AE and corresponding adjustment should be made. The Hon'ble High Court in the case of Sony Mobile Communication (India) Pvt Ltd. has rejected the contention of revenue on the applicability of bright line test and corresponding calculations. The Department has filed an appeal against the order of the Hon'ble High Court and contesting the judgment before the Hon'ble Supreme Court. Further, the Hon'ble DRP had also directed to apply bright line method for computation of ALP of AMP expenses for the AY 2013-14 vide its directions dated 28.09.2017.

3.2 The AMP/ sales of the final comparables as selected by the assessee are as under-

1 ^s - 1	Name of comparables	AMP expenditure	Sales turnover (Tn)	AMP / Sales
1	Advanced Micronic Devices Ltd.	11,86,741	44,86,16,502	0.26%
2	Dax Networks Ltd.	16,06,768	37,92,97,823	0.42%
3	Priya Ltd.	20,18,929	2,11,17,30,474	0.10%
4	Redington (India) Ltd.	54,01,64,000	2,28,99,05,57,	0.24%
5	Salora International Ltd	20,69,000	3,64,63,68.00	0.06%
Average AMP/ Sales ratio in case of comparable companies				0.22%
	Senheiser Electronics India	3,75,58,618	61,63,22,571	6.09%

3.3 The mean of the "expenditure incurred on AMP/sales" of such companies is the "bright line". Any expenditure in excess of the bright line is for the promotion of brand/trade name (which is owned by the AE) that needs to be suitably compensated by the AE. The amount which represents the bright line and the amount

that should have been compensated to the taxpayer company are computed hereunder:

Particulars	Value
Value of gross sales	61,63,22,571
AMP/Sales of comparables	0.22%
Amount that represent hi i&nt line	13,55,910
Expenditure on AMP by taxpayer	3,75,58,618
Expenditure in excess of bright line	3,62,02,708

3.4 Since the amount of Rs. 3,62,02,708/- was spent by the taxpayer company over and above the bright line limit for provision of services related to AMP purely for the AE, an independent entity under similar circumstances would have charged a mark-up on this amount, for the money spent and for the service element. The Hon'ble DRP had directed to apply mark up of SBI base rate plus 300 basis points in the case of the assessee for the AY 2012-13. The SB1 base rate comes to 9.75% for the FY 2012-13, Hence, mark up of 12.75% is applied on the amount of Rs. 3,62,02,708/- for computation of ALP.

3.5 Therefore, the taxpayer company should have been compensated by the AE at Rs. 3,62,02,708/- plus mark-up @ 12.75% (Rs. 46,15,845/-) for undertaking advertisement, marketing and publicity activities purely for AE and most importantly creating a marketing intangible for the AE. The net

adjustment therefore works out to Rs. 4,08,18,553/-. Accordingly, adjustment of Rs. 4,08,18,553/- is made on protective basis.

The Hon'ble DRP has directed to re-compute the adjustment by following the manner of computing ALM and ALP adjustment as demonstrated in para 8.1.3 of the DRP's order dated 28.10.2016 for the AY 2012-13. The calculation of adjustment for the year under consideration is as under-

S.No.	Particulars	Value (Rs.)
1	AMP expenses after excluding selling expenses (A)	3,75,58,618
	Reimbursement received from AE (B)	Nil
	Total expenditure incurred by assessee on AMP (C)	3,75,58,618
2	Sales	61,63,22,571
	C.O.G.S	38,86,69,622
	Gross Profit	22,76,52,949
	Markup (gross profit margin) (D)	58.57%
3	ALP of AMP expenses (E)=(C*D)+C	5,95,56,701
4	Adjustment u/s 92CA = (E)-(B)	5,95,56,701

Accordingly, adjustment of Rs. 5,95,56,701/- is made on substantive basis by using cost plus method.

5. Therefore, in view of the direction of the Ld DRP-1, New Delhi the earlier adjustment of Rs. 4,33,12,598/- is being revised to Rs 5,95,56,701/- on substantive basis. Besides, an adjustment of Rs,

4,08,18,553/- is being made on protective basis. The A.O. shall enhance the income of the assessee by an amount of Rs. 5,95,56,701/- in computation of its total income while passing the Final Order."

6. Aggrieved by this, the assessee is before us.

7. At the very outset, the ld. counsel for the assessee stated that the directions of the DRP followed by the TPO, applying Bright Line Method has been discarded by the Hon'ble Jurisdictional High Court of Delhi in Tax Appeal No. 16 of 2014 by listing its findings as under:

"18. Rejecting the application of bright line test, the Hon'ble High Court of Delhi has listed its findings as under:

" (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 the 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 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). 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 debundle 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 profit 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 interconnected international transaction and subjected to arm's length pricing."

8. Keeping in mind the aforesaid findings of the Hon'ble High Court of Delhi [supra], we find that the assessee company is engaged in the business of sales and distribution of headphones, microphones, receivers, monitoring systems, tour guide systems and aviation headsets. It also imports goods from Sennheiser group companies for reselling through its distributors in India. It also undertakes after-sales services.

9. The assessee has adopted TNMM as the most appropriate method with operative profit to sales as PLI and the same is as under:

International transaction	Transfer pricing method	Profit level indicator [PLI]	Sennheiser India Total value of transaction [Amount in NRI]	Margin	Comparables findings arithmetic mean
Purchase of Goods	Transactional Net Margin Method [TNMM]	Operating Profit/Operating sales [OP/Sales]	304238583	3.71%	2.57%
Provision of services			7584825		
Allocation of expenses paid			1609631		
Reimbursement of expenses paid			61,848		
Purchase of advertisement material			426.514		
Reimbursement of expenses received			1659460		

10. There is no quarrel so far as the most appropriate method i.e. TNMM is concerned. It can be seen from the aforementioned chart that the appellant's margin is 3.71%, whereas the comparable's margin is 2.57%.

11. It is true that there was no agreement, understanding or arrangement between the appellant and its AEs for incurrence of such expenditure by the appellant.

12. As mentioned elsewhere, the TPO has followed Bright Line Method for computing the ALP of the transaction. The appellant's AMP/sales ratio is at 6.09% and that of the comparables is 0.22%, taking a mark up of 12.75% on cost, which is wrongly adopted as cost plus mark up at 58.57% while giving effect to the directions of the DRP.

13. The functions performed by the AEs are manufacturing, Research and Development, Corporate Strategy and New Product Development and Marketing and Sales.

14. We find that the advertisement spend by the appellant was with a focus on selling the product by highlighting its features to potential customers on one to one basis, most commonly through direct mail, e-mail and online marketing.

15. In our considered opinion, the AMP expenses incurred were not with a view to benefit the AEs but to only increase the appellant's own sales.

16. The functions performed by Sennheiser group are described in the following para:

"Manufacturing

Sennheiser group manufactures its products at three factories, located at Germany, Ireland and the USA respectively. In addition, it uses capacities at long-term partner companies in Europe, Asia and America who fulfil their strict quality requirements.

The product portfolio of Sennheiser group includes microphones, Neumann microphones, wireless microphone and monitor systems, conference and visitor information technology, and headsets for aviation etc. In addition, the company provides central Logistics services for products manufactured by our Asian partner companies. Sennheiser India does not perform any manufacturing activity.

Research and development

Research and development activity is a centralized activity done by the AEs. The group has a large research and development centre in Germany and has research and development offices in California and Singapore⁹. Sennheiser India does not play any role in the research and development activity performed by the group.

Corporate Strategy

The ultimate parent company formulates the overall corporate strategy for the benefit of the entire group. The corporate strategy of Sennheiser India is based on the broader guidelines set by the ultimate parent company.

New Products development

AEs decide on the introduction of any new products and accordingly send relevant advertising and promotional materials to Sennheiser India for distribution to customers in its sales territory, this includes products and information and materials to be used in training the distributor's personnel.

Thus, the product conceptualization is the function of AEs and all related research & development activities are carried out by the AEs.

Sennheiser group owns the Intellectual Property Rights relating to products (patents), corporate logo/trademark, technical know-how (in the form of processes and technical data), quality standards, etc.

Marketing and Sales

AEs perform marketing activity through its wide network of dealers and direct sales force team for promoting and marketing the Products in order to expand its market share in the Territory and defend its market position as against its competitor.

The marketing strategy relating to positioning of new services or solutions, launching a new service line or solution, developing plans to capture a certain segment of the market, etc. are all developed by the AEs.

17. The functions performed by the appellant company are described in the following para:

"Sennheiser India procures head phones, microphones and wireless systems (hereafter the "Products"; from its AEs. The Company does not purchase any goods from any third party vendor. However, there is no sale to any AE by Sennheiser Electronics (India) i.e. the ultimate customers for the traded products are unrelated parties. The majority of the sales take place in the Indian Territory. The customers include Production Studios, Airlines, Audio & TV Channels, Call Centres in India.

The AE sells goods to the Sennheiser India at a price list which is same for all the other fellow subsidiaries. The Sennheiser India sells goods to distributors or other "middle men" at an approximate gross margin of 45%.

Distribution and inventory Management

Sennheiser India is responsible for its own inventory management. Sennheiser India sells in the domestic market against a confirmed order from the customer. Further, Sennheiser India maintains warehouses at various locations for facilitating distribution of goods in various parts of India.

Quality control is undertaken by each manufacturer before they are shipped to India. Once the goods reach the Indian shore, Sennheiser India also performs quality check.

Marketing & Sales of Finished Goods

Sennheiser India is responsible for distribution, invoicing, collection, ordering or delivery to the end-user as well as wholesalers.

Sennheiser India is responsible for marketing and other sales promotion activities. Marketing strategy required to be followed in India is performed by Sennheiser India

based on the broad guidelines as provided by Sennheiser group.

All the brochures and other marketing literature is designed and developed by Sennheiser India with inputs regarding brochure specification from the parent company. Sennheiser India is responsible for controlling and coordinating the marketing activities in India.

Sennheiser India also provides after sales support for both direct and indirect sales. Direct sales are the sales made by Sennheiser India to the customer in India, In respect of indirect sales AEs sell directly to customers in India.

Sennheiser India provides a warranty for the equipment supplied to the customer. In case of any warranty claims made by the customers Sennheiser India either repairs or replaces such goods. Thereafter, Sennheiser India is reimbursed for the actual expenses incurred for replacement/ repair under warranty, on cost to cost basis without any mark up by the AEs.

The Company also provides training to the customers with regard to the operation of the equipment. Sennheiser India handles all customer complaints as well as the billings and collection to/from the customers.

Training to the sales force regarding the operation and mechanism of the product is provided by Sennheiser India. Information on the Products and information and materials to be used in training the employees to perform the Marketing Services are developed by Sennheiser group at the request of Sennheiser India.

Administration

Sennheiser India is responsible for all its local administrative functions like, human resource,/recounting and IT. It also prepares its own financial statements."

18. The Id. DR had vehemently contended that since there was no agreement, understanding or arrangement between the assessee and its AEs, respective functions performed cannot be determined. The Id. DR further contended that since the Bright Line Test has been negative by the Hon'ble High Court, let the TPO adjudicate the issue afresh after determining the respective functions and frame de novo assessment.

19. We have given thoughtful consideration to this contention of the Id. DR. We do not find much force in the contention of the Id. DR because the TPO, while framing the order u/s 92CA(3) of the Act was well aware with the decision of the Hon'ble jurisdictional High Court of Delhi in the case of Soni Ericsson Mobile Communication India Pvt Ltd reported at 276 CTR 97, and therefore, it cannot be said that the TPO was not aware that the Bright Line test has been discarded by the Hon'ble High Court of Delhi. Relevant observations of the TPO are at page 8 of his order. It was only on the basis of Bright Line test that the impugned ALP adjustment was made, but that approach has already been negated by the Hon'ble High Court. Therefore, we see no reason to remit the matter to the file of the TPO as is prayed for by the Id. DR. A remand to the assessment stage cannot be a matter of routine. It has to be so done only when there is anything in the facts and circumstances to so warrant or justify. In our considered opinion, no new facts have emerged and all the facts brought on record during the course of assessment proceedings, do not indicate legally sustainable basis for remitting the matter to the file of the TPO.

20. Simply because the department has not accepted the judgment of the Hon'ble Jurisdictional High Court of Delhi, the binding nature of such judgment is not mitigated in any manner. Unless the Hon'ble Supreme Court reverses the judgment of any High Court, the same holds field, and remains binding on all the authorities working under its jurisdiction.

21. As mentioned elsewhere, the TPO has adopted cost and mark up of 58.57%, whereas the appellant earns gross margin of 34.30%. A bare perusal of the mandate of section 10B(1)(c) postulates under said clause (ii) that “*the amount of a normal gross profit mark-up to such costsin a comparable uncontrolled transactionis determined.*” Thus, it is vivid that it is adjusted g.p. mark-up of the comparables which is applied to the direct and indirect cost incurred by the assessee in respect of international transaction for determining ALP under cost plus method and there is no mandate for considering the assessee's own g.p. rate for this purpose. We, therefore, do not agree with the working done by the TPO in this regard.

22. We further find that the TPO has resorted to segregation of AMP expenses as a separate international transaction requiring independent bench marking by considering the same set of comparables as adopted by the assessee. The Hon'ble High Court of Delhi in the case of *Soni Ericsson Mobile Communication India [P] Ltd Vs. CIT ITA No. 16/2014* has held that once the Assessing Officer/TPO accepted and adopted TNMM but chooses to treat a particular expenditure like AMP as a separate international transaction without bifurcation/segregation, it would lead to unusual and incongruous results as AMP expenses was the cost or expenses and was not diverse. Even if the AMP expenses incurred by the appellant company are bench marked on a separate basis, no adjustment on account of AMP expenses would survive because of the following :

Particulars	Amount (Rs)
Operating Margins of the assessee (OP/Revenue)	3.71%
Revenue of the assessee (B)	61,63,22,894
Operating profit of the assessee (C = A*B)	2,28,37,894
AMP expenses (Excl. sales commission and discount)(D)	3,75,58,618
Operating Profit before AMP expenses, being separately benchmarked (E = C+D)	6,03,96,512
Arm's length operating margin (F)	2.57%
Arm's length operating profit (G = B*F)	1,58,39,490

Profit available for set off (H = E-G)	4,45,57,022 -
SBI Base rate plus 300 basis points adopted by TPO for benchmarking AMP expenses (I)	12.75%
Compensation for AMP expenses computed by TPO	4,08,18,553
Adjustment on Account of AMP expenses after set off (K = J-H)	(37,38,469)

23. Considering the facts of the case in totality from all possible legal angles, we do not find any plausible reason for TP adjustment on account of AMP expenses. We, accordingly, direct the Assessing Officer to delete the impugned adjustments.

24. In the result, the appeal filed by the assessee in ITA No. 7574/DEL/2017 is allowed.

The order is pronounced in the open court on 19.09.2018.

Sd/-

[SUDHANSHU SRIVASTAVA]
JUDICIAL MEMBER

sd/-

[N.K. BILLAIYA]
ACCOUNTANT MEMBER

Dated: 19th September, 2018

VL/

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR

Asst. Registrar,
ITAT, New Delhi

Date of dictation	
Date on which the typed draft is placed before the dictating Member	
Date on which the typed draft is placed before the Other Member	
Date on which the approved draft comes to the Sr.PS/PS	
Date on which the fair order is placed before the Dictating Member for pronouncement	
Date on which the fair order comes back to the Sr.PS/PS	
Date on which the final order is uploaded on the website of ITAT	
Date on which the file goes to the Bench Clerk	
Date on which the file goes to the Head Clerk	
The date on which the file goes to the Assistant Registrar for signature on the order	
Date of dispatch of the Order	