

IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCHES : I-1 : NEW DELHI

BEFORE SHRI R.S. SYAL, AM & SHRI KULDIP SINGH, JM

ITA No.5490/Del/2012
Assessment Year : 2008-09

Discovery Communications India,
9/1B, Secular House,
Qutab Institutional Area,
Aruna Asaf Ali Marg,
New Delhi.

Vs. DCIT,
Circle 10(1), Room
No.406, CR Building,
New Delhi.

PAN: AAACD4746K

(Appellant)

(Respondent)

Assessee By : Shri Manoj Pardasani, CA
Department By : Shri Amrendra Kumar, CIT, DR

Date of Hearing : 02.12.2015
Date of Pronouncement : 03.12.2015

ORDER

PER R.S. SYAL, AM:

This appeal by the assessee is directed against the final order passed by the Assessing Officer (AO) u/s 144C read with Section 143(3)

of the Income-tax Act, 1961 (hereinafter also called 'the Act') in relation to the assessment year 2008-09.

2. The only issue raised in this appeal is against the addition of Rs.12,15,11,974/- on account of transfer pricing adjustment of advertisement, marketing and promotion (AMP) expenses.

3. The appeal filed by the assessee was earlier disposed of by the Tribunal vide its order dated 13.9.2013 restoring the computation of ALP of AMP expenses to the TPO to be decided in accordance with the Special Bench decision in the case of *LG Electronics India (P) Ltd. vs. ACIT (2013) 152 TTJ 273 (Del) (SB)*. The assessee appealed against the Tribunal order. The Hon'ble jurisdictional High Court has disposed of the assessee's appeal in a batch of appeals with the leading order in *Sony Ericson Mobile Communication India (P) Ltd. vs. CIT (2015) 374 ITR 118 (Del)* restoring the matter to the Tribunal for a fresh decision in terms of the guidelines laid down by their Lordships in this judgment. That is how this appeal has come up for a fresh consideration before us.

4. Briefly stated, the facts of the case are that the assessee is a subsidiary of Discovery Channel (Mauritius) Pvt. Ltd. with Discovery Communication Inc., USA as the parent company of this group. The assessee is engaged in the distribution of Discovery Channel, Discovery Travel and Living Channel and Animal Planet Channel in India region and also sale of advertisement inventory on the channels. The assessee reported three international transactions which have been enlisted on page 2 of the order passed by the Transfer Pricing Officer (TPO). The assessee employed Transactional Net Margin Method (TNMM) as the most appropriate method for demonstrating that its international transactions were at arm's length price (ALP). On a reference made by the AO for determining the ALP of the international transactions, the TPO accepted the reported international transactions at ALP. He, however, observed that the assessee incurred AMP expenses to the tune of Rs.20,54,57,391/-. For determining the ALP of the international transaction of AMP expenses, he chose certain companies as comparables. By applying the bright line test, he worked out non-routine expenses incurred for developing intangibles in excess of bright line at

Rs.10,56,62,586/-. Adding the mark up of 15%, he worked out a transfer pricing adjustment of Rs.12,15,11,974/-. The assessee remained unsuccessful before the Dispute Resolution Panel (DRP). Eventually, the AO, vide his final order, made an addition of Rs.12.15 crore and odd on this issue. The assessee is aggrieved against this addition.

5. We have heard the rival submissions and perused the relevant material on record. Special Bench of the Tribunal in the case of *LG Electronics India Pvt. Ltd. Vs. ACIT (supra)*, by its majority decision held, *inter alia*, that AMP is a transaction and also an international transaction within the meaning of section 92B of the Act and that the TPO has jurisdiction to compute the ALP of this international transaction despite the same not having been specifically referred to by the AO. On the question of determination of the ALP of this international transaction, the Special bench approved the application of bright line test for working out the amount of non-routine AMP expenses and held that the ALP of AMP expenses should be determined on Cost plus method by treating AMP transaction as a separate and

distinct from other international transactions. It was further held that the selling expenses directly incurred in connection with the sales do not lead to brand promotion and hence should not be brought within the ambit of AMP expenses. The Special bench laid down certain parameters to be taken into consideration for determining the ALP of AMP expenses. In the ultimate analysis, the matter was sent back to the TPO for undertaking the exercise afresh in the light of its directions.

6. Following the said order, benches of the Tribunal decided several cases involving AMP expenses, restoring the matter to the file of AO/TPO for deciding this issue in conformity with the directions given by the Special Bench in *LG Electronics (supra)*. Several assessees as well as the Revenue preferred their respective appeals before the Hon'ble High Courts against the tribunal orders following the Special bench order. A batch of such appeals, also including the case of the assessee for the year under consideration, led by *Sony Ericson Mobile Communications India Pvt. Ltd. Vs. CIT (supra)* has been disposed of by Their Lordships of the Hon'ble Delhi High Court, upholding the

majority view of Special Bench in *LG Electronics (supra)* treating AMP as an international transaction and also conferring jurisdiction in the TPO to determine the ALP of the international transaction of AMP expenses. The Hon'ble High Court has held, *inter alia*, that the international transaction of AMP expenses should be bundled or aggregated with other international transaction carried out by the assessee as a distributor, who either simply acts an agent of manufacturer or purchases goods from the manufacturer for resale at his own account. However, in the case of a manufacturer, the import of raw material has been held to be an independent transaction of marketing and distribution. In the case of a distributor, the Hon'ble High Court held that where TNMM has been applied as the most appropriate method, which method has not been disturbed by the TPO, then, the international transactions of AMP and distribution activities should be clubbed. It further held that for determining the ALP of such transactions under a combined approach, only such comparables should be chosen which conform to the AMP functions and other distribution functions conducted by the assessee. If there is some difference in the functions

under these international transactions, including that of AMP, between the assessee and the comparables, then, suitable adjustment should be made to bring both the transactions at par. If probable comparables are not performing similar functions as done by the assessee and no adjustment is possible for bringing the international transactions of the assessee in an aggregate manner at par with those undertaken by the comparables, then, segregation should be done and the international transaction of AMP spend should be separately processed under the transfer pricing provisions for the purposes of determining its ALP separately. In such determination of ALP of AMP expenses in a segregated manner, proper set off on account of excess purchase price adjustment should be allowed. The view taken by the Tribunal in segregating routine and non-routine expenses on the basis of bright line test has been set aside by the Hon'ble High Court. The view taken by the Special Bench that the expenses concerned with the sales, such as, rebates and discounts etc., should be excluded from the ambit of AMP expenses, has been upheld.

7. We can summarize the relevant position emanating from the judgment of the Hon'ble High Court, as under : -

- AMP expense is an international transaction [Paras 52 & 53 of the judgment] ;
- The TPO has jurisdiction to determine the ALP of the international transaction of AMP expenses [Para 50 of the judgment];
- Inter-connected international transactions can be aggregated and section 92(3) does not prohibit the set-off [Paras 80 & 81];
- AMP is a separate function. An external comparable should perform similar AMP functions. [Paras 165 &166] ;
- Bright line test cannot be applied to work out non-routine AMP expenses for benchmarking [Para 194(x)];
- ALP of AMP expenses should be determined preferably in a bundled manner with the distribution activity [Paras 91, 121 & others] ;

- For determining the ALP of these transactions in a bundled manner, suitable comparables having undertaken similar activities of distribution of the products and also incurring of AMP expenses, should be chosen [Paras 194(i), (ii), (viii) & others];
- The choice of comparables cannot be restricted only to domestic companies using any foreign brand [Para 120] ;
- If no comparables having performed both the functions in a similar manner are available, then, suitable adjustment should be made to bring international transactions and comparable transactions at par [Para 194 (iii)] ;
- If adjustment is not possible or comparable is not available, then, the TNMM on entity level should not be applied [Paras 100, 121, 194(iii) & (vi)] ;
- In the above eventuality, international transaction of AMP should be viewed in a de-bundled manner or separately [Paras 121& 194(xi)] ;

- In separately determining the ALP of AMP expenses, the TPO is free to choose any other suitable method including Cost plus method [Para 194(xiii)];
- In so making a TP adjustment on account of AMP expenses, a proper set off/purchase price adjustment should be allowed from the other transaction of distribution of the products [Para 93] ;
- Selling expenses cannot be considered as part of AMP expenses [Paras 175 & 176 of the judgment].

8. With the above background of the *ratio decidendi* of the judgment of the Hon'ble jurisdictional High Court, let us examine the contention put forth by the ld. AR in support of the deletion of addition.

9. The ld. AR initially contended that the assessee is a service company and hence cannot be considered either as a Distributor or a Manufacturer. It was however admitted that considering the totality of the nature of business, the assessee is more akin to that of a Distributor rather than a Manufacturer. The Hon'ble High Court has dealt with the case of the assessee in a group of cases who are either distributors or

manufacturers. There is no separate discussion *qua* the assessee in the judgment on the determination of the ALP of AMP expenses. This shows that the assessee has not been considered by the Hon'ble High Court as belonging to a separate class other than a Distributor or a Manufacturer. Since the Id. AR has admitted that out of these two options, it is more close to a 'Distributor', we are proceeding accordingly by classifying it as a Distributor.

10. The Id. AR submitted that the assessee applied TNMM as the most appropriate method. Since the profit margin declared by the assessee was favourably comparable with the average margin of the comparables, which fact has not been disputed by the TPO, then, no adjustment should be made on account of AMP expenses because such expenses stand subsumed in the overall operating profit. This was countered by the Id. DR with reference to certain paras of the judgment in *Sony Ericsson (supra)* not permitting the acceptance of such a wide proposition.

11. We are unable to accept the argument advanced on behalf of the assessee for deletion of the addition towards AMP expenses on the plain

logic of the assessee's profit margin matching with those of comparables. There is a basic fallacy in the argument of the Id. AR. It is pertinent to note that the TPO examined and got satisfied with the assessee's profit margin *vis-à-vis* the comparables only *qua* the international transactions of distribution function. He determined the ALP of AMP expenses by applying bright line test and in this process simply compared the quantitative figures of AMP expenses incurred by the assessee and comparables for working out the non-routine expenses. He did not examine the AMP functions carried out by the assessee and the comparables. As the bright line test primarily concentrates on the quantitative aspects of the *AMP expenses* alone, it overlooks the examination of the *AMP functions* carried out by the assessee on one hand and the comparables on the other. Now, the Hon'ble High Court in *Sony Ericson Mobile (supra)* has held that AMP expense is a separate international transaction and also bright line test is not applicable for determining the ALP of AMP expenses. The manner for the determination of the ALP of the distribution activity and AMP activity has also been set out by the Hon'ble High Court to be conducted, firstly,

in a bundled manner by considering the distribution and *AMP functions* performed by the assessee as well as the probable comparables, and if probable comparables having performed both the functions are not available, then to determine the ALP of AMP expenses in a segregated manner. As such, it becomes immensely important to separately examine the Distribution and *AMP functions* undertaken by the assessee as well as probable comparables. It is vital to highlight the difference between the AMP expenses and AMP functions. Whereas the AMP functions are the means by which the AMP activity is performed, the AMP expenses are the amount spent on the performance of such means (functions). To put it simply, an examination of *AMP functions* carried out by the assessee and the probable comparables is *sine qua non* in the process of determination of the ALP of the international transaction of AMP spend, either in a segregate or an aggregate manner. What Their Lordships have held is to bundle the Distribution activity with the AMP activity, being two separate but connected international transactions, for the purposes of determination of the ALP of both these international transactions in a combined manner. The argument of the Id. AR, if taken to a logical

conclusion, will make the AMP spend as a non-international transaction, which, in our considered opinion, is not appropriate. Once AMP expense has been held to be an international transaction, it is, but, natural that the functions performed by the assessee under such a transaction need to be compared with similar functions performed by a comparable case. If AMP functions performed by the assessee turn out to be different from those performed by a probable comparable company, then, an adjustment is required to be made so as to bring the AMP functions performed by the assessee as well as the comparable, at the same pedestal. If we concur with the contention of the Id. AR that the addition on account transfer pricing adjustment of AMP expenses be deleted without any examination of the AMP functions carried out by the assessee as well as comparables, this will amount to snatching away the tag of international transaction from AMP expenses, assigned by the Hon'ble High Court. What Their Lordships have held in the judgment is that the Distribution activity and AMP expenses are two separate but related international transactions. It is only for the purposes of determining their ALP that these two should be aggregated. The process

of such aggregation does not take away the separate character of the AMP transaction, albeit related. An analysis and examination of the Distribution and AMP functions carried out by the assessee must be necessarily done in the first instance, which should be then compared with similar functions performed by some probable comparables. If the Distribution and AMP functions performed by the assessee turn out to be different from those performed by probable comparables, then, a suitable adjustment should be made to the profits of the comparable so as to balance the effect of such differences. If however differences exist in such functions, but no adjustment can be made, then, such probable comparable should be dropped from the list of comparables. If, in doing this exercise, there remains no company doing comparable distribution and AMP functions, then, both the international transactions are required to be segregated and then examined on individual basis by finding out probable comparables doing such separate functions similarly. For the international transaction of AMP spend, this can be done by, firstly, seeing the AMP functions actually performed by the assessee and then comparing it with the AMP functions performed by a probable

comparable. If both are found out to be similar, then the matter ends and a comparable is found and one can go ahead with determining the ALP of such a transaction. If the AMP functions performed by the two entities are found to be different, then adjustment is required to be made in the case of a probable comparable, so as to make it uniform with the assessee. The assessee may have possibly done, say, four different AMP functions as against the probable comparable having done, say, only three. In such a scenario, again the adjustment will be warranted. In another situation, the AMP functions performed by the assessee and probable comparable may be similar but with varying standards, which will also call for an adjustment. Crux of the matter is that the AMP functions performed by the assessee must be similar to those done by the comparable, in the same manner as such functions are compared in any other international transaction. However, in computing ALP of AMP spend, the adjustment or set off, if any, available from the Distribution function, should be made. The essence of the judgment in the case of *Sony Ericson Mobile (supra)* is that the two international transactions of Distribution and AMP should be examined on the touchstone of transfer

pricing provisions, but on an aggregate basis. Determining the ALP of two transactions in an aggregate manner postulates making a comparison of both the functions of Distribution and AMP carried out by the assessee with the comparables, so that surplus from the distribution activity could be adjusted against the deficit in the AMP activity. The Hon'ble High Court has nowhere laid down that the AMP functions performed by the assessee should not be compared with those performed by the comparable parties. On the contrary, it turned down the contention raised by the ld. AR urging for not treating AMP as a separate function, which is apparent from the extraction from para 165 of the judgment : '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'. It held vide para 165 of the judgment that : '*An external comparable should perform similar AMP functions.*' Thus it is manifest that comparison of AMP functions is vital which cannot be dispensed with. Let us we go a step further with the alternative prescription of the judgment that if ALP of both the

transactions of Distribution and AMP cannot be determined in a combined manner, then the ALP of AMP function should be separately done. The submission advanced by the assessee of considering the profit on an entity level without making comparison of AMP functions done by the assessee as well as the comparable, will render this alternative approach incapable of compliance. Canvassing such a view amounts to treating AMP spend as a non-international transaction, which is patently incapable of acceptance.

12. Adverting to the facts of the instant case, we find that the TPO accepted TNMM as the most appropriate method and did not make any TP adjustment on account of the reported international transactions carried out by the assessee during the course of its business. He, however, espoused the AMP expense as a separate and distinct item. Treating the AMP spend as a separate international transaction, he applied the Cost plus method and proposed the extant adjustment. In doing so, he segregated routine AMP expenses incurred by the assessee for his business from the non-routine AMP expenses by treating such

non-routine AMP expenses leading to the creation of marketing intangible for its AE. This bifurcation of total AMP expenses was done by applying bright line test. It is obvious that in the entire exercise carried out by the TPO, he proceeded on an altogether different line in examining the quantum of AMP *expense* for determining the value of the international transaction of AMP, without looking at the AMP *functions* carried out by the assessee and the comparables. Distinct examination of AMP functions does not find place in this method of computing the value or the ALP of AMP spend. Now, when we look at the *ratio* laid down by the Hon'ble jurisdictional High Court, it becomes crystal clear that the approach adopted by the TPO for determining ALP of AMP expenses has been rendered incorrect. However, the fact remains that as per the verdict of the Hon'ble High Court, the AMP spend is an international transaction, which is required to be processed under Chapter X of the Act by taking into account the AMP functions performed by the assessee and then comparing such functions with those performed by comparable entities, though, firstly in a combined manner with the distribution functions. We find no reference to the AMP

functions carried out by the assessee in the order of the TPO. As such, there can be no question of making any comparison of the assessee's AMP functions with those of the comparables. Going by the *ratio* in the case of *Sony Ericson Mobile (supra)*, it is mandatory to make a comparison of the AMP functions performed by the assessee and comparables and then making an adjustment, if any, due to differences between the two, so that the AMP functions performed by the assessee and comparable are brought to a similar platform. In fact, this is also the prescription of Rule 10B(1)(e), which provides as under :-

(e) transactional net margin method, by which,—

(i) the net profit margin realised by the enterprise from an international 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 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.'

13. A perusal of the sub-clause (iii) of this Rule divulges that net profit margin under a comparable uncontrolled transaction as determined under sub-clause (ii) should be: "adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions." It is only such adjusted net profit margin in sub-clause (iii) of Rule 10B(1)(e) which is compared with the net profit margin realized by the assessee as per the mandate of sub-clause (iv) of Rule 10B(1)(e).

14. Sub-rule (2) of Rule 10B provides that 'for the purposes of sub-rule (1)', the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely — (a) the specific characteristics of the property transferred or services provided in either transaction ; (b) the functions

performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions ; (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions ; (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail. Sub-rule (3) of Rule 10B stipulates that an uncontrolled transaction shall be comparable to an international transaction if (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market ; or (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

15. On a comparative reading of sub-rules (1), (2) and (3) of Rule 10B, it becomes palpable that the international transaction and the uncontrolled transaction with which comparison is sought to be made for determining the ALP, in the first instance, must have overall similar characteristics. It is vivid that if the goods/services are different, then no effective comparison can be made. Once the goods/services under both the transactions are broadly similar but there is a difference in them because of certain specific characteristics; and/or the products/services in both the transactions are identical, but still there are certain differences due to the contractual terms or the geographical location, etc., then, a reasonably accurate adjustment should be made for eliminating the material effects of such differences so as to bring the international transaction and the comparable uncontrolled transaction on the same podium. If due to one reason or the other, no reasonable accurate adjustment can be made due to such differences, then, such uncontrolled transaction should not be considered as a comparable transaction.

16. It is discernible that the prescription of Rule 10B is in complete harmony with the *ratio* of the judgment in the case of *Sony Ericson Mobile (supra)*, to the effect that the AMP functions carried out by the assessee are required to be necessarily compared with the AMP functions carried out by a comparable entity in determining the AMP of ALP expenses. Difference between the functions, if capable of adjustment, should be given effect to in the profit rate of the comparable and if such difference cannot be given effect to, then, the probable comparable should be eliminated from the list of comparables. Going further, if no proper comparable survives, then the TNMM should be discarded and an alternative method, may be, Cost plus or any other suitable method be applied for determining the ALP of AMP expenses.

17. At the cost of repetition, we summarize that the Distribution and AMP functions are two separate international activities, which need to be compared with uncontrolled transactions. Because of their inter-twinning, it is only for the purposes of determining their ALP that both these transactions can be aggregated in the first instance, so that the

surplus from one could be adjusted against the deficit from the other in an overall approach. It does not mean that because of aggregation, the AMP expense transaction sheds its character of a separate international transaction and hence the AMP functions should not be matched with the AMP functions carried out by probable comparables. If suitable comparables can be found having performed both Distribution and AMP functions, then, their ALP should be determined on aggregate basis. If, however, there is some difference in the Distribution or AMP functions performed by the assessee *vis-à-vis* the probable comparables, then an attempt should first be made to iron out such difference by making a suitable adjustment to the profit margin of comparables. If such an adjustment is not possible, then such probable comparable should be eliminated. If, by making a comparative analysis of the Distribution and AMP functions jointly, there remains no comparable case performing such distribution and AMP functions, then, the international transaction of AMP should be segregated and its ALP be determined separately by applying a suitable method. However, in so determining the ALP of such an international transaction of AMP expenses on separate basis, a

proper set off, if any, available from the distribution activity, should be allowed.

18. Coming back to the facts of the instant case, we find that no detail of the AMP functions performed by the assessee is available on record. Similarly, there is no reference in the order of the TPO to any AMP functions performed by comparables. In fact, no such analysis or comparison has been undertaken by the TPO because of his applying the bright line test for determining the value of the international transaction of AMP expense and then applying the cost plus method for determining its ALP. The Id. AR also failed to draw our attention towards any material divulging the AMP functions performed by the assessee as well as comparables. As such, we are handicapped to determine the ALP of AMP expenses at our end, either in a combined or a separate approach. The Id. AR has also disputed the base of total AMP expenses taken by the TPO. He argued that some of expenses, which are in the nature of selling expenses directly incurred in connection with sales not leading to brand promotion in any manner, should be excluded. In principle, we

agree with the contention of the Id. AR that Selling expenses incurred for making sales are distinct from AMP expenses and, hence, should not be included in the base amount for consideration. The Hon'ble jurisdictional High Court in *Sony Ericson Mobile Communication India (P) Ltd.* (supra) has also held so. As there is inappropriate discussion about the precise nature of expenses which have been assailed before us, we consider it expedient to direct the AO to first ascertain the correct nature of such expenses. If these expenses are found to be in the nature of Selling expenses directly in connection with sales, then, they should be removed from the base amount for computing the ALP of AMP expenses. In the otherwise scenario, the AMP expenses, which are not in the nature of Selling expenses incurred directly for sales, should continue to include in the base amount. Under such circumstances, we set aside the impugned order and send the matter back to the file of the TPO/AO for determining the ALP of the international transaction of AMP spend afresh in accordance with the manner laid down by the Hon'ble High Court in *Sony Ericson Mobile (supra)*.

19. In the result, the appeal is partly allowed for statistical purposes.

The order pronounced in the open court on 03.12.2015.

Sd/-

[KULDIP SINGH]
JUDICIAL MEMBER

Sd/-

[R.S. SYAL]
ACCOUNTANT MEMBER

Dated, 03rd December, 2015.

dk

Copy forwarded to:

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

AR, ITAT, NEW DELHI.