

Transfer Pricing e-Alert

23 AUGUST 2018

Transfer Pricing For Marketing Intangibles

Transfer pricing adjustments for excessive advertisement and promotional (**A&P**) expenses and marketing intangibles have always been a thorny issue in Malaysia. The Inland Revenue Board (**IRB**) has been conducting transfer pricing audits on multinational companies, where the IRB examines whether the Malaysian entities had incurred excessive A&P expenses on behalf of associated enterprises who are the brand owners to which such expenses relate.

Apart from an ongoing tax appeal on this issue before the Special Commissioners of Income Tax, in which our firm is representing the taxpayer in the appeal, there is no case law precedent in Malaysia concerning this issue specifically. However, the Delhi bench of the Income Tax Appellate Tribunal gave a new dimension to this topic in the recent case of *Luxottica India Eyewear Pvt Ltd v ACIT (ITA No 344/Del/2017)*.

Brief facts

The taxpayer is part of the global Luxottica group that specialises in the manufacturing and trading of sun glasses and prescription frames. The taxpayer's role in India is to import and sell such goods, effectively operating a trading house. When the Indian Commission of Income Tax (**CIT**) audited the taxpayer, the primary issue that arose was whether in incurring A&P expenditure, the taxpayer was sufficiently reimbursed by its associated enterprise, which is the brand owner. The A&P expenditure relates to the taxpayer's efforts to promote sales in India. The CIT took the position that the taxpayer had incurred an excessive amount of A&P expenditure, as the value of the brand owned by the associated enterprise has increased due to such marketing efforts. It was subsequently ruled by the CIT that as such, marketing intangibles were created in favour of the associated enterprise and it ought to be reimbursed.

In CIT's benchmarking exercise on the importation of goods by the taxpayer, it adjusted the operating margins of the comparable companies on the premise that there are

Contact persons:

Datuk D. P. Naban
Senior Partner,
Tax, SST & Customs Practice
+603-6208 5858
dpn@lh-ag.com

S. Saravana Kumar
Partner,
Tax, SST & Customs Practice
+603-6208 5813
sks@lh-ag.com

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differences in the intensities of A&P expenditure between the taxpayer and such companies. The CIT found that the taxpayer's A&P activities were much less extensive than the said companies. Subsequently, the CIT treated such expenses as a "function" performed by the taxpayer as a part of its role and responsibility as a distributor, which effectively embeds the A&P expenses in the primary transaction, i.e. the importation of goods. What the CIT did not do was to treat it as a separate international transaction to be benchmarked separately. In addition, the CIT also used the transactional net margin method (**TNMM**) instead of the resale price method that was used by the taxpayer.

Tribunal's findings

The tribunal held that that a distinction is required to be drawn between "a function" and "a transaction" and that every expenditure forming part of the function cannot be construed as a transaction. As such, the tribunal took the position that the A&P expenditure incurred by the taxpayer does not fall within the purview of an "international transaction", but must instead be treated as a "function" undertaken by the taxpayer. The tribunal ruled that it is legal for the CIT to make an adjustment after carrying out the intensive A&P adjustment of the comparable companies.

However, the tribunal added that the resale price method used by the taxpayer is more appropriate as the main business of the taxpayer was to carry on trading of sunglasses and frames where the goods purchased were sold without making any value addition. As such, it was held that the resale price method was the most appropriate method in preference over the TNMM. The tribunal stated that in carrying out the intensive A&P adjustment, and if it could not be done for any reason, a different suitable methodology other than the resale price method can be used to encompass the adjustment.

In respect to the application of an appropriate base for computation of proportionate adjustment, the tribunal found that since the international transaction involved is the purchase of finished goods, it would be appropriate to take into account the total cost of finished goods purchased and the suitable base for determination of the adjustment.

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www.lh-ag.com

Lee Hishammuddin Allen & Gledhill

Level 6, Menara 1 Dutamas

Solaris Dutamas

No. 1, Jalan Dutamas 1

50480 Kuala Lumpur

Malaysia

Tel: +603 6208 5888

Fax: +603 6201 0122

Email: tax@lh-ag.com

Our views

The significance of this case is that the Indian courts have accepted the CIT's treatment of marketing activity as a function undertaken by a distributor. However, since the intensity of marketing conducted by the taxpayer was higher than the comparables, an economic adjustment on the margins was conducted and this was again allowed. Unfortunately, there are no specific details on intensity adjustments in the OECD Transfer Pricing Guidelines or the Malaysian Transfer Pricing Guidelines at this stage. Hence, should this issue become a larger concern in the near future, further guidance will be needed from the IRB or even the legislature.

The Malaysian jurisprudence on transfer pricing might not have reached the scale of the Indian courts yet, but it is imperative to bear in mind that the IRB is estopped from using A&P expenses as a reason to benchmark a taxpayer against the comparable companies' margins solely. It must instead go to great lengths of conducting a detailed functional analysis which would include the A&P function and expenses, ascertaining comparables and comparable analysis and subsequently carrying out intensive A&P adjustments when necessary.

Please contact us at tax@lh-ag.com if you have any queries on transfer pricing matters.

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Contact persons:

Datuk D. P. Naban
Senior Partner,
Tax, SST & Customs Practice
+603-6208 5858
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