

Taxing advertising and marketing spends

MS Ananth explains why promotional expenses have been a subject matter of tax litigation



Why do AMP expenses lead to tax disputes?

Advertising, marketing and promotion (AMP) expenses incurred by an Indian entity may cause benefit to an overseas related party or an associated enterprise (AE). Treatment of AMP expenses is an issue that has arisen in transfer pricing regulations under the Income Tax Act, 1961, which regulates 'International Transactions' between two or more AEs.

International transactions have a wide and inclusive definition under the IT Act. AE is defined in the IT Act and includes related parties as defined under Indian law. The transfer pricing (TP) regulations provide that transactions between AEs should be at 'arm's length price' (ALP). If the transactions are not at ALP, the tax authorities have the power to review the transaction.

The TP regulations are broader; it is not limited to disallowance of expenses.

How do marketing intangibles complicate tax computations?

Marketing intangibles are not defined in the IT Act. However, for the purpose of TP regulations, 'intangible property' has been explained to include marketing-related intangible assets, such as trademarks, trade names, brand names and logos. Under Indian law, these would generally be regarded as trademark property and copyrighted material.

Courts have ruled that in certain circumstances marketing intangible may be created in favour of the foreign AE.

What has been the contention of the tax department?

1. Domestic entities that incur huge (beyond a reasonable/comparable limit) AMP expenses are helping create marketing intangible for a foreign AE
2. All AMP expenses benefit foreign AE and in all scenarios, Indian entity should be compensated
3. Tax department should be empowered to determine reasonable AMP expenses

How do taxpayers counter these claims?

1. Indian entities also benefit from AMP expenses. These help increase sales that lead to higher profits
2. Indian entities are 'economic owners' and hence have a vested interest in developing and promoting their licensed brands. However, the concept of economic ownership is not recognised under the IT Act
3. AMP expenses are incurred by making payments to unrelated third parties (for example, ad agencies/online channels). These expenses are not an international transaction and are not transactions with AEs to begin with

How is the case relating to Flipkart's discounts related to AMP?

The tax department argued that discounts were excessive and the expenses were in the nature of capital expenses and not revenue expenses. The expenditure was such that it would provide a benefit of enduring nature and hence, it was treated as a marketing intangible. Tax department argued that marketing intangibles were created through discounts. However, the Bangalore Tax Tribunal rejected the contention and ruled that the expenses were revenue and not capital. The argument on the creation of an asset (in the nature of marketing intangible) was also rejected. Although not related to the TP regulations and the issue of AMP, this case shows that the principle of marketing intangibles may be applied in a different context by the tax department.

What is the current status?

Appeals from the Delhi High Court and other courts relating to AMP and marketing intangibles are pending with the Supreme Court. The Bangalore ITAT ruled in favour of Flipkart in April 2018 and as of date, no appeal has been filed yet.