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'Brightline' Test – Revenue's Dictat on Marketing Intangibles

In recent times, in a number of cases, the Revenue has challenged the huge advertising spend and marketing effort undertaken by Indian subsidiaries for promotion of foreign brands (legally owned by parent). In all such cases, significant Transfer Pricing adjustments have been made where the quantum of marketing expenditure was found to be in excess of the 'bright line'[1] (while these adjustments surfaced largely during the fifth round of Transfer Pricing audit, they peaked in the sixth round concluded last, post Delhi High Court Decision in the case of *Maruti Suzuki*[2]).

Concept of 'bright line'

In simple terms, 'bright line' is a watermark defining the limit of 'routine' or 'permissible' marketing expenditure. In other words, 'bright line' is an estimate of marketing expenditure that would ordinarily be undertaken by any player in a given industry. The determination of 'bright line' is a factual question dependent upon a host factors – nature of industry, stage in the business lifecycle, susceptibility of product demand to promotion etc.

At this juncture, we may quickly look at Revenue's position on determination and application of the 'bright line'. In the first instance, comparable product or service providers are identified and their average marketing spend is determined. Thereafter, the 'excess' of taxpayer's marketing expenditure over and above such 'average' is disallowed on the ground that it fails the industry standard. Revenue's argument for disallowance is that the 'excessive' expenditure benefits only the parent (whose brand is promoted) and not the subsidiary.

[1] The concept was used for the first time in a celebrated US Court of Appeals decision in the case of DHL in 2002.

[2] The recent Delhi High Court Judgment in the case of Maruti Suzuki created quite a flutter by endorsing Revenue's stand on marketing intangibles at least in part. However, a subsequent Supreme Court decision rendered the High Court order ineffective. Even so, the High Court judgment continues to inspire findings of the Tax Department in implicit ways.

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'Legal' and 'economic' ownership

Inextricably linked with the concept of 'bright line' is the concept of 'economic' ownership. Ownership of an intangible can be 'de-jure' ie 'legal' ownership based on legal registration and like formalities or 'economic' or 'de-facto' ie ownership based on contribution towards or critical decision making in respect of the intangible's development. The decision making can relate to the quantum of marketing expenditure, its direction, scope, nature and other such modalities pertaining to brand building. The locus of legal and 'economic' ownership may often coincide or it can even remain separate - a finding that needs to be made separately in each factual setting.

Revenue's argument based on 'bright line' takes cognizance primarily of 'legal' ownership to the complete disregard of 'economic' ownership (it needs to be borne in mind that the onus to demonstrate 'economic' ownership would vest with the taxpayer who must satisfactorily prove that legal ownership is divorced from flow of economic benefits).

Planning for defence

The deployment of the 'brightline' concept raises a host of questions – both from a planning ('*ex-ante*') and audit defense ('*ex-post*') perspective. The solution in each case is highly case specific entailing examination of the following inter-related factors:

Functional profile having regard to Transfer Pricing policy/ supply chain

What is the documented and actual functional profile of the Indian entity - whether it is an entrepreneur or a limited risk entity? While an entrepreneur would spend on brand building and bear the risk and reward of market expansion and greater recognition, a limited risk entity by definition is incapable of doing the same.

Nature of parent–subsidiary relationship as evidenced from inter-company agreements/ documents

Long term and exclusive business relationship between parent and subsidiary justifies significant marketing expenditure as the Indian entity gets sufficient time to reap rewards of the marketing effort. A third party would also insist on similar terms before incurring significant advertising expenditure for promoting a brand that is legally owned by another.

Locus of critical functions (also known as 'significant people functions')

Economic ownership needs to be examined from view point of factual reality and not just theory or written documents alone. In the end substance shall prevail over form. Hence, to determine economic ownership, it needs to be examined from where are the critical decisions in relation to the development and deployment of the intangible being undertaken.

Nature and quality of comparables

The set of chosen comparables resulting in a low 'average' for marketing spend may itself require correction. In such a case the FAR (functions, assets and risk) analysis and the choice of comparables needs to be re-visited to arrive at the correct 'bright line'.

In short, a thorough examination of the above factors is required to build defense and assist in substantiating 'economic' ownership of the intangible by the Indian entity. Benefit from brand building, if any, flowing to the parent would be incidental (despite legal ownership) and can be ignored for all practical purposes.

purposes. International and OECD commentary amply support the view that incidental benefits are in the nature of 'stewardship' services not requiring a 'quid pro quo.'

From a perusal of the above factors, it is clear that considerable pre-emptive action is required at the planning and documentation stage. For example, the choice of comparables (at the documentation stage) needs to be made judiciously for audit is ex-postand correcting a self-committed wrong subsequently is never easy.

On the whole, the case for economic ownership needs to be built with utmost care after a comprehensive survey of the rights and obligations of each transacting entity. Just as tax authorities have awakened to the concept of 'bright line', through pre-emptive safeguards in planning and documentation, the tax management should also be ready to counter any departmental challenge.

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