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Special Bench ruling on marketing intangibles in case of LG Electronics India Pvt. Ltd.

In brief

The much awaited ruling of the special the bench of Delhi Income-tax Appellate Tribunal (the Tribunal) in respect of marketing intangibles in the case of LG Electronics India Pvt. Ltd.[1] was pronounced yesterday.

LG Electronics Inc. (LGK or the associated enterprise or AE) is a Korean company engaged in the manufacture, sale and distribution of electronic products and electrical appliances. LG Electronics India Pvt. Ltd. (LGI or the taxpayer) is its wholly owned subsidiary in India. During the transfer pricing (TP) assessment proceedings, the transfer pricing officer (TPO) alleged that the assessee has incurred excessive advertising, marketing and promotion (AMP) expenses in comparison to comparable companies. The difference was considered by the TPO to be AMP incurred by the taxpayer on brand promotion for the AE, which should have been compensated by the AE to the taxpayer. The TPO thus made an adjustment for the difference, which was upheld by the Dispute Resolution Panel (DRP). The DRP Panel additionally observed that a mark-up on the AMP expenses was also warranted. Against the order of the DRP, LGI filed an appeal with Delhi Tribunal.

While adjudicating the appeal, the Tribunal concluded that, based on the facts of the case, the TP adjustment in relation to the AMP expenses incurred by the assessee for creating or improving the marketing intangible for and on behalf of the AE is permissible. The Tribunal also held that earning a mark-up from the AE in respect of AMP expenses incurred on behalf of the AE is also allowable.

[1] LG Electronics India Pvt. Ltd. *v.* ACIT [2013] 29 taxmann.com 300 (Delhi) (SB)

Facts

LG Electronics Inc. (LGK or the associated enterprise or AE) is a Korean company engaged in the manufacture, sale and distribution of electronic products and electrical appliances. LG Electronics India Pvt. Ltd. (LGI or the taxpayer) is its wholly owned subsidiary in India. LGI, in the capacity of a licensee, obtained from LGK, i.e., the licensor, a right to use the technical know-how for manufacture, marketing, sale and services of its products, for which a royalty of 1% was agreed. The licensor allowed the licensee, for no charge, to also use its brand name and trademarks (hereinafter collectively referred to as brand) for products manufactured in India.

During the course of TP assessment proceedings, the TPO observed that the AMP expenses were 3.85% of the taxpayer's sales. The TPO computed similar percentage in the case of Videocon Appliances Ltd. (0.12%) and Whirlpool of India Ltd (2.66%) with their arithmetic mean at 1.39%. The difference was considered by the TPO to be excess AMP incurred by the taxpayer on brand promotion for the AE, which should have been compensated by the AE to the taxpayer. The TPO thus made an adjustment for the difference. The DRP concurred with this view and additionally observed that a mark-up (of 13%) on the AMP expenses was also warranted for the opportunity cost of the funds deployed[2] (10.5%) and the efforts of the taxpayer (2.5%). Aggrieved, the taxpayer appealed before the Tribunal. A Special Bench of the Tribunal (SB) was constituted to adjudicate the following two questions[3]:

"1. Whether, on the facts and in circumstances of the case, the assessing officer was justified in making transfer pricing adjustment in relation to advertisement, marketing and sales promotion expenses incurred by the assessee?

2. Whether the assessing officer was justified in holding that the assessee should have earned a mark up from the Associated Enterprise in respect of AMP expenses alleged to have been incurred for and on behalf of the AE?"

Contentions of the parties and Ruling of the SB

The SB addressed the judgement in different parts, details of which are outlined below.

Jurisdiction of TPO

The taxpayer contended that the TPO was not justified in assuming jurisdiction over such international transaction in the absence of any reference made to him by the assessing officer (AO). The SB held that this issue stands diluted or vacated in view of the retrospective amendment made by the Finance Act, 2012[4], and validated the jurisdiction of the TPO in examining a transaction even though not expressly referred to him by the AO.

Existence of transaction

The taxpayer contended that there exists no transaction of creation of marketing intangible by brand building for the AE, as there was no understanding oral or written between the AE and the taxpayer, and because the AMP expenses were incurred for the taxpayer's business purposes. The taxpayer also contended that the Revenue could not re-characterise the transaction by splitting it into two parts, viz., AMP expenses relating to the taxpayer's business, and AMP expenses towards brand building for the AE.

The SB held that an agreement between AEs can be formal or in writing, or informal or oral. The critical test would be the conduct of the parties to the transaction. If the taxpayer has advertised the brand of the AE (which was held to

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[2] Except where a reimbursement was immediately received after the expense had been incurred.
[3] One out of the three members of the SB passed a dissenting judgment. However, for this analysis, we have considered only the "majority" judgment of the SB, since only that in essence, is the operative ruling.

[4] *Vide* insertion of sub-section 2B to section 92CA of the Income-tax Act, 1961 (to be effective retrospectively from June 1, 2002).

be so in the instant case based on the facts), then it can be inferred that there is an understanding between the taxpayer and its AE to this effect. Moreover, the disproportionately higher AMP expenses incurred by the taxpayer *vis-à-vis* independent enterprises behaving in a commercially rational manner, lends further credence to this inference. The SB accordingly held that a transaction did exist whereby the taxpayer incurred AMP expenses towards promotion of brand which was legally owned by the AE.

Furthermore, the SB made a distinction between the concept of advertising and marketing for the product, which it associated with the licensed manufacturer; and advertising and marketing for the brand, which it associated with the legal owner of the brand. The Tribunal mentioned that if the licensed manufacturer incurred AMP expenses to promote the value of the brand, as opposed to promoting the product, which it was selling, in that case, to the extent such AMP expenses, as a percentage of turnover, would exceed the same of comparable companies, then such licensed manufacturer could be said to be rendering a service to the legal owner of the brand, for which a compensation in the form of reimbursement was required.

Economic *v.* legal ownership

The SB held that economic ownership of a brand is a concept which exists only in a commercial sense. To explain, the SB stated that the taxpayer and the middlemen in a supply chain can be considered as economic owners of a brand only in a commercial sense as they all exploit the brand for furthering their sale. To further explain, the SB hypothesized that if the AE (the legal owner) sold its brand, then the sale consideration would not be shared amongst such economic owners and would vest only with the legal owner. Therefore, the SB eventually held that in the context of the Indian Income-tax Act, 1961 (the Act), it is only legal (and not economic) ownership which is recognized.

International transaction

One of the key contentions of the taxpayers was that payment for AMP expenditure would not qualify as an international transaction under the Indian transfer pricing regulations. The taxpayers contended that payment for AMP expenditure was made to third parties in India. Further, there was no consideration between the taxpayer and its AEs for provision of brand building services. Thus, the AMP expenditure should not be covered within the ambit of Indian transfer pricing regulations.

In this regard, the Tribunal observed that it was not the contention of Revenue that payment made to third parties in India is an international transaction; rather the taxpayer has provided brand building service to the AE by incurring such advertisement expenditure. The Tribunal held that, there is a transaction of creating and improving marketing intangibles by the taxpayer for the foreign AE; foreign AE is a non-resident; such transaction is in the nature of provision of service. Hence, the Tribunal held that the revenue authorities were fully justified in treating the transactions of brand building as an international transaction in the facts and circumstances of the present case.

Bright line is not a method permitted under Indian regulations

The taxpayers contended that bright line test is not a prescribed method under the Indian transfer pricing regulations and hence application of the same to the taxpayers' case is invalid. In relation to the same, the Tribunal observed that bright line test is a tool to identify the cost of non-routine marketing expenditure incurred by the taxpayer for providing brand building service to its AEs and not as a method for determining the arm's length nature of the transaction. As the taxpayer has not provided the cost of excess marketing expenditure, the Revenue has used the bright line test to identify the excess marketing cost considering the routine AMP expenditure of the comparable companies. Further, the Tribunal has held that the revenue authorities have applied mark-up over the non-routine cost to determine the value of brand building service by application of cost plus method (CPM).

Interplay between sections 37(1), 40A(2) and 92

The taxpayer contended that AMP expenditure was incurred wholly and exclusively for the purpose of its own business and are deductible as an expense under section 37(1) of the Act.

In this regard, the Tribunal in its order has discussed the interplay between sections 37(1), 40A(2) and section 92 and held that Section 92 is much wider in its ambit and extends beyond the provisions of section 37(1) and section 40A(2). The Tribunal stated that the TP provisions are special provisions and once there is an international transaction, these provisions shall prevail over the general provisions under section 37(1).

Methods for determining ALP of international transaction

The assessee has contended that no disallowance can be made out of AMP expenses by benchmarking them separately when the overall profit declared by the assessee is higher than other comparable cases. In response to the assessee's contention, the Tribunal held that the computation of arm's length price (ALP) of an international transaction on the entity level is inappropriate. The Tribunal appreciated the basic TP principles and held that the correct approach under the transactional net margin method (TNMM) is to consider the operating profit from each international transaction separately and not the profitability of the assessee as a whole on entity level.

The Tribunal observed that various factors contribute to the earning of profit by stating that the purchase cost is only one of several other important factors having a bearing on the overall profit. All other costs, including the AMP expenses are independent of such cost of import of raw material, having some correlation with the overall profit. The Tribunal held that if there are several unrelated international transactions, as in the instant case, benchmarked applying the TNMM in a wrong manner on entity level, then the remedy lies in correcting such mistake rather than drawing legally unsustainable conclusions by taking such mistake as a correct legal position. Earning an overall higher profit margin in comparison with other comparable cases cannot be considered as a license to the assessee to record other expenses in international transactions without considering the benefit, service or facility out of such expenses at arm's length.

Determination of ALP

While discussing the determination of ALP of the international transaction of AMP expenses, the Tribunal stated that the first thing which is required to be done is to find out some comparable uncontrolled transactions for determining cost/value of the international transaction and then ascertain the profit mark-up of such comparable uncontrolled transaction.

<u>Relevant factors for determining the cost of the service</u>

The SB mentioned various factors which have bearing on the question of determination of the cost/value of the international transaction and which need to be kept in view before selecting the comparable companies. These factors *inter alia* include characterisation of the entity, payment for technology/trade-name in any form, subsidy received from the AE in any form, etc. While accepting the contention of the assessee about necessity of choosing proper comparable cases, the SB stated that companies using the foreign brand cannot be accepted. The comparable domestic companies not using foreign brand need to be included. The Tribunal has also held that the TPO was not justified in restricting himself only to the two comparable cases without verifying or discussing the comparability of cases cited by the assessee.

<u>Application of mark-up</u>

The SB upheld the action of the DRP of applying mark-up in respect of the AMP expenses incurred on behalf of the AE. However, the SB stated that the DRP went wrong in arbitrarily determining the rate of mark-up at 13% without showing as to how much an independent comparable entity has earned from an international transaction similar to one which is under consideration.

Expenses to be covered in AMP while determining cost/value

The SB stated that AMP expenses refer only to advertisement, marketing and publicity expenses. While promotion of sales directly lead to brand building, the expenses directly in connection with sales are only sales specific and does not result into creation of brand and should not be included in the total AMP expenditure while determining cost of the service. It was also mentioned that the judgements rendered in the context of sections 37(3A) and 37(3B) will squarely apply to the interpretation of the scope of AMP expenses and therefore, the judicial pronouncements dealing with the matter of inclusion/exclusion of certain expenses from total AMP expenses would also be applicable to the issue in hand.

Maruti Suzuki's case

The SB held that the Delhi High Court ruling in the case of a writ application filed by Maruti Suzuki India Ltd.[5] was still very much alive and has not been diluted by the Supreme Court.

Conclusion by SB

The SB concluded by stating that the TP adjustment in relation to the AMP expenses incurred by the assessee for creating or improving the marketing intangible for and on behalf of the AE is permissible. Secondly, earning a mark-up from the AE in respect of AMP expenses incurred on behalf of the AE is also allowable.

However, the SB restored the matter to the file of the AO/TPO for determining the cost/value of international transactions in the first instance and then the ALP of this international transaction by determining the correct mark-up in light of certain guidelines outlined in the ruling.

[5] Maruti Suzuki India Ltd v. Add CIT [2010] 192 TAXMAN 317 (DELHI)

PwC observations

The issue of marketing intangibles is one concerning the fundamentals of economics and transfer pricing. Nonetheless, recourse was taken to certain legal arguments which the SB has dismissed.

As regards the SB's verdict on merits, it would be worthwhile to highlight at the very outset that any issue of marketing intangibles requires an in-depth factual analysis, depending upon the functional, asset and risk (FAR) profile of each taxpayer and its AEs. A common dictum, on merits, which would apply across the board is accordingly difficult to lay down. Thus, to a great extent, the observations of the SB should be restricted and read in the context of the facts of LGI (which, it is understood from the ruling of the Tribunal, was a licensed manufacturer). Having said that, provided below is our analysis of the key observations made by the SB.

The SB has discarded the concept of economic ownership for the purpose of transfer pricing. However, a blanket dismissal of the same does not seem appropriate for the primary reason that the worth of a brand arises essentially from its usage and where its value is created or enhanced. If the significant people functions around advertising and marketing are performed by the licensee leading to brand value creation or enhancement, then the licensee becomes the economic owner of the brand to that extent. In which case, if the rights of the licensee are impaired at the time the legal owner sells the brand, the licensee may seek a compensation for the brand value created or enhanced by it, depending on the terms of the license agreement, the level of investment made in the brand by the licensee, etc. This finds support in the Guidelines provided by the OECD and the Australian Taxation Office (ATO) on business restructuring in the context of 'exit charge'.

The fundamental approaches of TP need to be followed by appreciating the characterisation of the entities based on their FAR profile and accordingly, selecting the correct tested party. The genesis of the entire dispute around

marketing intangibles in the case of licensed manufacturers lie in the incorrect approach of TP through wrong “tested party” for the purpose of benchmarking analysis. The same principle would also apply to entrepreneurial buy sell companies, whose results should again not tested against the comparable companies. It is imperative to select the right tested party and to undertake transaction by transaction analysis demonstrating that the residual profit resides in India.

The Tribunal while laying down the principles regarding selection of appropriate comparable companies mentioned that companies using foreign brand cannot be accepted. However, it was not appreciated that taxpayers which are entrepreneurial licensed manufacturers, at first place, cannot be tested whether for arriving at the arm’s length price of transactions or for the purposes of comparing their AMP expenses.

The Tribunal stated that each international transaction should be separately benchmarked and even if under overall TNMM, the taxpayer’s profitability is higher than average profit level indicator (PLI) of the comparables, it does not preclude the Revenue to look at each transaction separately. However, as stated earlier, the said observations based upon the facts of the cases wherein the assessee was a licensed manufacturer. Therefore, the observations of the Tribunal need to be restricted and read in the context of the facts of the licensed manufacturer and not distributors.

The SB has stated that mere fact of the assessee having spent higher amount on advertisement in comparison with similarly placed independent entities cannot be considered as conclusive to infer that some part of the advertisement expenses were incurred towards brand promotion for the foreign AE. The SB also observed that if any decision taken by the Indian AE is found to be uninfluenced by the overseas AEs, then the transaction is accepted as such by the Revenue at its face value. Accordingly, the SB in effect advocated the concept of ‘Key people function’ to determine whether there is a provision of service and who should bear the cost of advertisement.

The Tribunal has specifically mentioned that based on the facts of the case (wherein the SB held that the marketing and sales strategy was in effect developed by the group company), it was considered to be a transaction pertaining to provision of service by the main applicant. Accordingly, it is very important to understand that the dictum of the ruling of the SB needs to be restricted to the facts and circumstances of the case of LG India. In cases where it can be demonstrated that there has been no provision of service by the taxpayer by differentiating the facts and circumstances, the observations of the Tribunal would not be applicable.

Concluding remarks

The current issue around marketing intangibles is highly factual, depending upon the FAR profile of each taxpayer, for which a common dictum could not have been laid down on merits of the issue, applying to taxpayers across the board. The resolution on merits in the issue of marketing intangibles is far from over, particularly for distributors, the facts relating to which had not been covered or dealt with by the SB.

Taxpayers who are entrepreneurs would be well advised to adopt the correct approaches and fundamentals of TP in dealing with the issue of marketing intangibles, since necessary characterisation through FAR analysis; and selection of the proper ‘tested party’, whereby such entrepreneurs would not be required to be tested against other comparables, which is the only way to a proper resolution for the relevant issue.

Our Offices

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Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	**Bangalore** 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	**Bhubaneswar** IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	**Chennai** 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006 Phone +91-44 4228 5000	**Hyderabad** #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-33 2357 9101 / 4400 1111 Fax: (91) 033 2357 2754	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

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