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L.G. Electronics Decision May Prove Dubious Victory for Indian Tax Authority

An Indian court's summary dismissal of the economic ownership concept involving brand intangibles in the recent case of *L.G. Electronics India Private Ltd.* ultimately may do more harm than good for the Indian Revenue Service because foreign investment in the country exceeds outbound investment, according to a New Delhi practitioner. **[*L.G. Electronics India Private Ltd. v. Assistant Commissioner of Income Tax,* Delhi Special Bench ITAT No. 5140 of 2011, decision filed 1/23/13]**

Ashutosh Mohan Rastogi of Amicus Advocates & Solicitors told BNA Feb. 24 that by focusing only on the legal title to intangibles, the *L.G. Electronics* decision may enable foreign multinationals to effortlessly repatriate funds through royalty payouts, and the ruling also may make it difficult for the Indian Revenue to contend that those payouts should be restricted when a foreign brand is built from scratch in India.

Thus, the ruling on economic ownership cuts both ways, Rastogi said—''in fact, looking at the bigger picture, one even wonders whether the L.G. ruling is really a victory for Indian Revenue.''

The Special Bench of the Delhi Income Tax Appellate Tribunal, in a 2-1 decision, held Jan. 23 that the nation's transfer pricing officers may use the ''bright-line test'' to determine the arm's-length price of advertising, marketing, and promotion (AMP) expenses that are incurred by an Indian related party in order to build its foreign parent's brand.

Rastogi said that for transfer pricing purposes, it is generally accepted that legal ownership is not the only factor determining the return attributable to an intangible. Recognition of the brand development effort also is critical; therefore, any entity bearing such burden must be commensurately rewarded for its effort. The determination of the return attributable for any economic activity is contingent on the functions performed, assets employed, and risks assumed, he said.

Brand Expenses. In *L.G. Electronics*, 15 companies joined the proceedings as interveners, with the Delhi ITAT upholding the TPO's decision to apply the bright-line test, thus disallowing AMP expenses incurred by L.G. Electronics India Private Ltd. that were incurred to build the brand of its foreign parent, L.G. Electronics Inc. Korea. The expenses were excessive in comparison to those incurred by two domestic comparables.

Mukesh Butani of BMR Legal in New Delhi told BNA Feb. 19 that although the ITAT found that such excessive expenses on brand development constituted an international related-party transaction under Indian law, the tribunal directed the tax inspector to make a new adjustment taking into account that some of the advertising expenses related to sales of products.

Butani pointed out that the tribunal laid down principles regarding benchmarking of such transactions. ''This is clearly a relief to taxpayers and the nature and quantum of relief will vary from taxpayer to taxpayer.''

Rastogi said the tribunal's majority opinion drew a distinction between expenditure for brand and expenditure for product promotion. It is only the general brand promotion expenditure—which does not relate to any specific product sold in the host country—that constitutes an ''international transaction.'' In the tribunal's view, such expenditure does not directly benefit the Indian subsidiary, he said.

Special Bench. Rastogi explained the significance of the fact that the ruling in *L.G. Electronics* was made by a Special Bench of the Indian Income Tax Appellate Tribunal instead of the usual two-member Division Bench that ordinarily hears and decides tax appeals.

A special three-member bench is constituted for issues of far-reaching importance, and other taxpayers affected by the same issue are given the opportunity to present their arguments as ''interveners.''

Rastogi said a ruling by the Special Bench on a particular question of law is binding on all other Division Benches of the tax tribunal—''hence, the L.G. ruling assumes tremendous significance.''

Unless a taxpayer is able to differentiate itself based on the facts of its case, Rastogi said, the *L.G. Electronics* ruling will apply to other taxpayers on the decided questions of law.

However, he said L.G. Electronics India is likely to appeal the ruling and that other taxpayers still may succeed on the marketing intangibles issue based on the distinctive facts of their own cases.

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Butani said the decision of the Special Bench will be binding on all taxpayers whether or not they intervened, and it is up to the coordinate benches to decide the matter for each taxpayer keeping in mind the Special Bench decision.

Taxpayers in general doubt the correctness of the decision, Butani said, and in all likelihood will appeal to the Delhi High Court after a determination by the coordinate benches.

Foreign Brand. The tribunal in a 117-page decision found that a proportion of the AMP expenses were excessive because they were incurred by the Indian subsidiary in order to promote the foreign parent's brand and that the parent should compensate the subsidiary on an arm's-length basis for these expenses.

The bright-line test seeks to determine a taxpayer's excess AMP expenditure by calculating the amount by which the expenses exceed the average of AMP expenditure of comparable companies. The ITAT found that if the Indian subsidiary's AMP expenses, as a percentage of turnover, exceed those of comparable companies, then the subsidiary is deemed to be rendering a service to its foreign parent.

In addition to finding that the Indian subsidiary had incurred AMP expenses to improve its foreign parent's brand, or marketing intangible, the tribunal found that the subsidiary also was entitled to a markup on those expenses.

The tribunal distinguished between AMP expenses incurred by the Indian subsidiary in order to promote its parent's brand and expenses the subsidiary incurred to advertise, market, and sell the products.

AMP Expenses. In the case before the Delhi ITAT, L.G. Electronics Inc. Korea granted a license to its wholly owned subsidiary, L.G. Electronics India, to use technical information, designs, drawings, and industrial property rights in order to manufacture, market, sell and service electronic products, including televisions, washing machines, and refrigerators. L.G. Electronics Inc. Korea charged its subsidiary a 1 percent royalty.

The Korean parent also allowed its Indian subsidiary to use the L.G. Electronics brand name and trademarks for products manufactured and sold in India on a royalty-free basis.

The TPO concluded that L.G. Electronics India was promoting the LG brand because the company had incurred AMP expenses of 3.85 percent of its sales, compared to an arithmetic mean of 1.39 percent of sales for two comparables, Videocon Appliances Ltd. (0.12 percent) and Whirlpool of India Ltd. (2.66 percent).

The TPO applied the bright-line test finding that L.G. Electronics India should have been compensated for the expenses in excess of 1.39 percent of sales because such expenses were incurred in order to promote L.G. Electronics Inc. Korea's brand promotion, and therefore proposed a transfer pricing adjustment of 1.6 billion rupees ($29 million) for assessment year 2007-08.

The dispute resolution panel upheld the TPO's decision and added a markup of 13 percent on some of the expenses.

L.G. Electronics India appealed the decision to the Delhi ITAT.

Comparables. The Delhi tribunal said there is not a straitjacket formula for weighing the 14 factors. Rather, "it is the collective effect of the above factors in the comparable case and the case to be compared with, which needs to be kept in view before determining the cost/value of the international transaction."

It is the duty of the TPO to give due regard to such factors, the tribunal said, by making suitable plus or minus adjustments before finally determining the cost and value of the international transaction.

The tribunal rejected the TPO's assertion that comparable cases must use a foreign brand, saying the AMP expenses in these cases would include a contribution toward brand building. "[T]he comparison would become meaningless as their total AMP expenses will stand on the same footing as that of [L.G. Electronics India] before the exclusion of expenses in relation to brand building for the foreign AE."

The correct way to make a meaningful comparison, the ITAT said, is to choose comparable domestic cases not using any foreign brand.

Benchmarking. The tribunal listed 14 questions that bear on determining the cost and value of brand and logo promotion when an Indian associated enterprise incurs AMP expenses for the benefit of its foreign entity:

1. Is the Indian associated enterprise a distributor, or does it hold a manufacturing license from its foreign associated enterprise?
2. When the Indian enterprise is not a full-fledged manufacturer, is it adding value to the goods purchased from the foreign associated enterprise before it sells them to customers?
3. Do the goods sold by the Indian enterprise bear the foreign enterprise's brand name or logo?
4. Do the goods bear a joint logo of both the Indian entity and its foreign counterpart?
5. Is the Indian manufacturer paying a royalty "or any similar amount by whatever name" to its foreign associated enterprise for the use of the brand name or logo?
6. Is the royalty comparable to what other domestic entities pay to independent foreign parties in a similar situation?
7. When the Indian associated enterprise has a manufacturing license from the foreign associated enterprise, is it also using technology, technical input, or technical know-how acquired from its foreign enterprise for the purposes of manufacturing such goods?
8. When the Indian enterprise is paying the foreign enterprise for using the technical know-how, is the payment toward only fees for technical services or does it

include a royalty for the use of the brand name or brand logo?

9. Is the foreign enterprise compensating the Indian entity for the promotion of its brand in any form, such as providing a subsidy for the goods sold?

10. Is the amount of the subsidy commensurate with the expenses incurred by the Indian entity on the promotion of the foreign entity's brand?

11. Does the foreign associated enterprise have a presence in India in only one or several fields, are different Indian associated enterprises looking after the different fields, and what is the pattern of AMP expenses of the Indian entities?

12. Is the foreign brand an established brand in India?

13. Has the Indian entity launched any new products in India during the relevant period or is it continuing the business with an existing range of products?

14. How will the brand be dealt with after the termination of the related-party agreement between the Indian and foreign enterprises?

The tribunal remanded the case to the TPO to select appropriate domestic comparable companies that are not using foreign brands, and also to determine an appropriate markup.

Impractical Distinction. Rastogi said the ITAT's distinction between product and brand expenditures is not practicable because it is nearly impossible to track and quantify expenditure on brand and products separately. He added that the distinction merits reconsideration legally as well.

What happens, Rastogi asked, when an Indian distributor has an exclusive long-term right to exploit a licensed trademark? Does it matter whether the marketing expenditure targets specific products sold by the Indian distributor or targets the foreign brand in general?

Rastogi said that in both cases it is only the Indian distributor who stands to benefit from the marketing expenditure as the sole and exclusive ambassador of the brand in India.

By Kevin A. Bell