

LG Electronics - A Dubious Victory For Revenue?

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While much has been already written on the recent Special Bench Decision in the case of LG Electronics, this article focuses on two fundamental issues relating to brand expenditure and the concept of economic ownership.

Distinction between product and brand expenditure

The majority view in the LG case has drawn a distinction between expenditure for brand and product promotion. As per the majority view, it is only the general brand promotion expenditure (which does not relate to any specific product sold in the host country) which constitutes an 'international transaction'. In view of the Tribunal, such expenditure does not directly benefit the Indian Subsidiary.

The above distinction does not seem practicable for following reasons:

- (i) Practically, it is extremely difficult if not impossible to track and quantify expenditure on brand and on products separately;
- (ii) Legally as well the distinction merits re-consideration. What happens where the Indian distributor has exclusive long term rights for exploitation of the licensed trademark? In such a situation it does not matter whether marketing expenditure targets specific products sold by Indian distributor or the foreign brand in general – 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. Not surprisingly, in OECD Transfer Pricing Guidelines, US Regulations as well as the ATO (Australian Tax Office) Guidelines on marketing intangibles, emphasis has been placed on the nature of licensing rights (whether exclusive and long term) as against the 'product' versus 'general brand' related expenditure.

Economic Ownership Concept

The Tribunal has also ruled that 'economic ownership' is merely the ownership of an intangible in a commercial sense **which is not recognized under the Indian Tax Code. The Tribunal has held that for purposes of the Indian Tax Code only 'legal ownership' is recognized.**

For Transfer Pricing purposes it is generally accepted that legal ownership of an intangible is not the only factor determining the return attributable to it. Recognition of the brand/ intangible development effort is also critical and hence, any entity bearing such burden must also be commensurately rewarded for such effort.

With due respect, the most disappointing aspect of the LG Tribunal Ruling is the somewhat cursory treatment of the 'economic ownership' concept. Since the likelihood of taxpayer's appealing to the High Court is extremely high, one cannot say that this is the last word on the question of economic ownership under the Indian Tax Code. Whatever may be the final outcome, non recognition of economic ownership is fatal for Transfer Pricing in the Indian context for following reasons:

Functional Analysis is bedrock of Transfer Pricing Analysis

Under Indian Transfer Pricing Regulations as well as internationally, functional analysis constitutes the bedrock of Transfer Pricing analysis. The determination of the return attributable for any economic activity is contingent upon the functions performed, assets employed and the risks assumed. As in other cases, Transfer Pricing of intangibles is no exception.

While it is true that Indian Transfer Pricing regulations do not refer to the concept of economic ownership in so many words, the same is nonetheless tacitly enshrined in the requirement of functional analysis. As in case of any other economic activity, the development of an intangible can also be a joint activity wherein the economic

return to each member is governed by its respective role. The concept of *'income arising'* is presumably broad enough to ensure that the 'economic owner' of an intangible is attributed sufficient reward for developing the intangible. Further, 'economic nexus' or the locus of functions, assets and risks has always been an important argument in Indian Tax Jurisprudence and was also applied in so many words by the Supreme Court in Morgan Stanley while discussing profit attribution to PE.

At Odds with International Practice

In the recently released Discussion Draft on Transfer Pricing of Intangibles, OECD has accorded precedence to 'significant people functions' (and the allied concept of 'economic ownership') for determining return attributable to intangibles. While OECD Guidelines are not binding upon Indian Tax Authorities or Courts, Indian Courts have often taken the cue from same for resolving contentious issues.

A Dubious Victory for Revenue

The summary dismissal of 'economic ownership' concept may ultimately do more harm than good for Indian Revenue as investment in/from India is still inbound focused. Hence, focussing only on the legal title to intangibles may enable foreign multinationals to effortlessly repatriate funds through royalty pay outs. Following the LG Ruling, it may be difficult for Indian Revenue to contend that royalty pay outs should be restricted since the foreign brand was built from scratch in India. Hence, the LG Ruling on 'economic ownership' cuts both ways. In-fact looking at the bigger picture, one even wonders whether LG Ruling is really a victory for Indian Revenue.

Way Forward and Tax Planning Implications

While discussing the implications of the LG Ruling the most important fact to be kept in mind is that it is a *'Special Bench'* Ruling of Indian Tax Tribunal. A two member bench ('Division Bench') of the Tax Tribunal ordinarily hears and decides the tax appeals. However, where a maiden issue of far reaching importance presents itself a 'Special' three member bench is constituted. A ruling by the Special Bench on a particular question of law is binding upon all other Division Benches of the Tax Tribunal.

Hence, the LG Ruling assumes tremendous significance. **Unless a taxpayer is able to differentiate itself based on the facts of its case, the LG Special Bench ruling shall equally apply to other taxpayers on the decided questions of law.** Having said that, two important caveats need to be noted; (1) the Ruling is most likely to be appealed against by the taxpayer (LG Electronics) and hence, may not be the final word as yet; and (2) other taxpayers may still succeed on the marketing intangible issue based on the distinctive facts of their own case.

Another important question is that how do multinational companies plan their affairs in the interim? Should they take it as a 'given' that India accords importance only to legal ownership or should they factor brand building efforts in a tax planning exercise? It may be premature to comment but in the long run it appears that *'significant people functions'* (and hence economic ownership) in relation to intangible development cannot be ignored. It seems surprising how the LG Ruling has been decided *de-hors* any discussion on the significant people functions pertaining to 'LG' brand creation in India.

For interim it also needs to be noted that one Tribunal Member has passed a dissenting opinion in the LG case. Hence, the litigation is far from over and one would eagerly look forward to the High Court verdict once LG appeals further (which seems most likely).

Views expressed are personal.