INDIA

SPECIAL BENCH RULING IN LG ELECTRONICS - 'TRANSACTION' DEFINITION TOO WIDE?

On a plain reading of the judgment in the *LG Electronics India Private Ltd* case, advertising, marketing and promotional (AMP) expenses in excess of those in comparable cases are treated as brand building promotional activities. However, this judgment has raised certain interesting thoughts/arguments which are quite different from other judgments on similar lines. In addition, Mr Hari Om Maratha's dissenting opinion has thrown a twist into the judgment. One of the principal points at issue was whether *incurring higher AMP expenses over and above those in comparable cases are brand building promotional activities for the associated enterprise (AE) and thus it is a "so-called Transaction"*.

This can be analysed as follows:

The word "Transaction" is defined under section 92F of the Income Tax Act for the purpose of the broader definition of "international transaction". In analysing the above section the Income Tax Appellate Tribunal (ITAT) concluded that it is not necessary to have a formal agreement or understanding to prove that an arrangement is to be termed a "transaction". In their analysis, they emphasised that the words "whether or not" at the beginning of the sentence allow them to draw that conclusion.

After having concluded that no formal agreement is required, they went on to analyse the various facts in order to determine whether any arrangement exists; such arrangement would appear to include both implicit and explicit arrangements, whether recorded or not. Here, the emphasis was more on an implicit arrangement. In that connection, the ITAT observed that:

a) If the expenses were incurred for building the brand of the foreign entity, that is in the nature of an implicit arrangement and hence a 'transaction'. At this juncture, the amount of expenditure does not matter. While concluding this, the ITAT overruled the concept of "presumption based transaction" as laid down by the Supreme Court;
b) Even if the expenditure incurred by a company is proportionately much higher, the so-called comparable cases cannot be the basis to conclude that such part of excess expenditure can be attributed to a brand building exercise for a foreign AE. This means, as explained by the ITAT in subsequent paragraphs, that if a company incurs extraordinary expenditure towards AMP but does not display the name of the foreign AE then, irrespective of the amount, it cannot be concluded that there is any socalled implicit arrangement, and hence no 'transaction' with a foreign AE.

The ITAT proceeded to analyse the facts and circumstances, based on these two guiding principles.

Various video clips were produced during the course of the hearings, which demonstrated that LG India's advertising included the logo of the foreign AE and also advertisements of products which are not manufactured by LG India. Further, to strengthen the arguments, the global strategy (Blue Ocean Strategy) of marketing was discussed at length, also highlighting the agreement entered into between the AE and LG India to demonstrate that the Indian company's expenditure is influenced by the AE. Thus, on the above facts, the ITAT concluded that there was an implicit arrangement between them.

The Organisation for Economic Co-operation and Development (OECD) has discussed the circumstances under which a tax officer can disregard a transaction and substitute it with a new transaction. The same principles were also discussed in the judgment of EKL Appliances by the Delhi High Court. In that case, two circumstances were suggested: (a) if the economic substance of the transaction is found to be different from the form, and (b) if the economic substance and the form are the same, then the arrangement made in relation to the transaction has to be looked in totality, whether it differs from what would have adopted by an independent entity behaving in a commercially rational manner.

The same principles were also discussed in the instant case in order to distinguish itself from the EKL ruling.

The discussion was one-sided, emphasising only the commercial factor, as the ITAT categorised it under the second circumstance. The word 'totality' was not properly factored, the reason being that if any company incurs a very high expenditure on so-called AMP, then one has to look at such expenditure, if it helps in contributing to the bottom line of the company or not. If yes, then economically, one is spending the money to earn profit for oneself and not for others. Accordingly, one is justifying the commercial aspect of the OECD guidelines and also looking at the totality. Secondly, one is assuming that in the transactional net margin method (TNMM) analysis the profitability of the company (as a whole) is higher than in comparable cases. If that is so, then the excess (so-called non-routine) expenditure is justified, as the company is earning a higher operating profit. It is also true that almost all of the multinational enterprises (MNEs) operating in India have to use their global logo, which an independent Indian entity (often considered as comparable) cannot use, and MNEs are governed by the global policies of using the same logo. Do ITAT's observations mean that if any company which is manufacturing and selling/ using the technology of the foreign brand owner, that automatically becomes an implicit transaction?

It is true that most large MNEs have one global marketing strategy, and at times they develop common pamphlets, designs and wordings, which are to be used by the global subsidiaries. The global strategy serves as a guide which is to be used by the local entity. It would appear that this does not automatically trigger any influence of the foreign AE in the Indian subsidiary, as most of the time, each jurisdiction is sufficiently independent to take a decision on the approach to be followed. Consequently it fixes its own investment/ budget depending upon the business dynamics of the jurisdiction.

It would appear, with the insertion of subsection (2A) of section 92CA of the Income Tax Act, function asset and risk (FAR) analysis becomes paramount, and has to be very exhaustive in order to capture any such implicit understanding not only relating to brand building but also various other aspects of the business, including risk. For each company, the fact pattern of the case is very important to analyse and fit into the overall pronouncement of this ruling.

Thus, overall, the judgment has at various places made some critical observations which would be relevant, and is important for all Transfer Pricing practitioners.

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