LG - AMP - TP - Bad news to business

In a sort of yet another landmark judgment the Special Bench of the Income Tax Appellate Tribunal ('ITAT') has ruled on several critical matters concerning the transfer pricing issues in *L.G. Electronics India Private Limited v. Assistant Commissioner of Income Tax* which are likely to have tremendous bearing on many commercial transactions between an Indian Taxpayer and its foreign Associated Enterprise ('AE'). The issues before the SB were:

- *Whether, the Assessing Officer was justified in making transfer pricing adjustment in relation to advertisement, marketing and sales promotion expenses incurred by the assessee?*
- *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?*

In summary this lengthy judgment broadly charts out the scope of enquiry to be undertaken in respect of AMP (advertising, marketing and Promotion) Expenses by the TPO and the matter is remanded back to the TPO to complete his assessment in the lines as in the ruling.

In substance, the AMP expenses which include advertisement expenses that can be attributed to brand / logo of the Parent have far reaching consequences in the context of transfer pricing transaction and could potentially lead to disallowance, where they according the the TPO does not seem areasonable expenditure incurred under arms-length valuation.

Facts

L.G. Electronics India Private Limited ('LG'), a wholly owned subsidiary of the Korea based company L.G. Electronics Inc. ('LGKorea'), is engaged in the manufacture, sale and distribution of electronic products and electrical appliances. The two companies entered into a foreign collaboration agreement in 1997, and technical assistance cum royalty agreement in 2001. Through these agreements LG as licensee obtained rights to use technical information, designs, drawings and other rights including the right for manufacture, marketing, sale and services of the products from the LGKorea. Although use of LGKorea brand name and trademark was without the payment of royalty, a clause provided for payment of royalty at any future date.

The TPO held that LG had received sums of monies from LGKorea for expenses incurred by LG in connection with the expenditure incurred on sponsorship of Global Cricket events. The quantum of contribution was considered as a part of contribution for the brand promotion carried by LG on behalf of LGKorea. The TPO computed the AMP expenses at 3.85% of its sales which was above the mean percentage of 1.39%, according to the TPO,spent by other similar companies. Applying the 'bright line'test as laid down by the United States Court of Appeal in *DHL Corporation & Subsidiaries v. Commissioner of Internal Revenue*, the TPO held that the expenses above 1.39% was incurred for promotion of LGKorea's brand and consequently, slapped the transfer pricing adjustment.

In the appeal before the DRP, as usual, the DRP concurred with the AO and calculated a mark-up of 13% on expenses. The ITAT dismissed the appeal remanded the matter for fresh consideration by the TPO.

Issues before the ITAT

In terms of the submissions made by the parties before the ITAT several issues were for consideration, however this article restricts the same to a few of them, considered important by the author.

Meaning of 'Transaction':LG contended that to invoke the provisions of transfer pricing there should be 'transaction' between LG and LG KOREA. The expenditures were infact purely for promoting its business in India, paid to Indian third parties who were not AE, on commercial basis andtherefore, could not be termed at international transactions at all.

The Department however argued that the AMP expenses incurred by the LG were more than

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the normal standards and to the extent of the additional expenses, as computed by the department was to promote the brand and logo of the LG Korea.

To this effect, the Hon'ble ITAT held that the definition of 'transaction' includes an arrangement, understanding or action in concert, whether or not it is formal or in writing; or intended to be enforceable by legal proceeding. It further held that while the Taxpayer could decide how much expense was to be incurred to carry on his business smoothly, it had to be determined whether there was any arrangement and for that purpose to ascertain whether an independent enterprise behaving in a commercially rational manner would incur expenses to the extent the taxpayer has incurred. Based on the facts of the case, the ITAT concluded that the Taxpayer had incurred expenses proportionately more than that incurred by independent enterprises behaving in a commercially rational manner which therefore resulted in promotion of the brand legally owned by the foreign AE and therefore, there was a 'transaction' between the Taxpayer and the foreign AE.

However, the ITAT negated the arguments of the Department that while LG was incurring "proportionately higher amount" on AMP, it can be assumed that a part of the same had been incurred towards brand promotion for the foreign AE.

The ITAT further, in para 9 & 10 of the judgment held that brand building by a taxpayer is a transaction for the purpose of section 92B of the IT Act. The ITAT further held that the "additional expense" incurred on behalf for the foreign AE for brand building is provision of service.

Analysis of certain sections of the Act: It was argued by the Taxpayer that any sum disallowed under section 92 should be allowed as a deduction under section 37 as expenses incurred wholly for the purpose of the business and that the Department could not interfere with reasonable business expenses. The Taxpayers also sought to contend that payments which were 'wholly' and 'exclusively' for the purpose of business could not be disallowed under section 40A(2) as well as held in CIT v. Nestle India Limited (2011) 337 ITR 103 (Bom.). However ITAT rejected this argument on the basis that Section 92 being a special provision was applicable to international transactions whereas section 40A (2) was general in nature.

To the above arguments, the ITAT held that disallowance under section 37 was under the premise whether an item of expense was for the business of the taxpayer or not. With reference to the present case, the expenditure was incurred by LG for benefit of its AE, LG Korea, and hence were to be disallowed.

The ITAT concluded that section 40A(2) determines reasonableness of expenditure while section 92 questions the very admissibility of the expenditure. Section 37 would also not provide relief since the expenses in question are disallowed on the ground that the same are not for the business of the taxpayer.

On the matters of valuation and the markup applied by the DRP, the Hon'ble ITAT remanded the issue back to the TPO to adjudicate appropriately.

Conclusion:

While restraining this article only to the AMP part of the ruling, the ITAT has ruled that the benefit is accruing to LF Korea in every marketing expenditure of LG. This analogy can be drawn to all the multinational companies in India with the effect that the AMP of all their Indian arm could be subjected to a TP addition. The one fact which the Indian companies couldplace before the authorities is that the logo of the companies would have the trademark of the Indian entity as mandated in the IP laws of India. This is definitely not the end, but the beginning of the AMP battle.

The remand to the TPO on the valuation and the analysis of markup crops another important issue as to how the TPO could go back on the findings of the DRP being the TPO's superior officers!