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TAX FLASH NEWS

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Deemed brand development is not a separate international transaction

Background

The Chennai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Hyundai Motor India Limited[1] (the taxpayer or HMIL), deleted the INR350 crore transfer pricing (TP) adjustment [Assessment Year (AY) 2009-10 to AY 2011-12] stating that deemed brand development is not a separate international transaction and highlighted that the taxpayer's case is different from the special bench ruling in the case of LG Electronics[2].

Facts of the case

- The taxpayer, being a wholly owned subsidiary of Hyundai Motor Company, Korea (HMC), is involved in manufacturing and sale of cars using the brand 'Hyundai', whose legal owner being Hyundai Motor Korea.
- The taxpayer is to mandatorily use the badge with trademark Hyundai in every vehicle manufactured by it as per the intercompany agreement entered into between the taxpayer and HMC.
- During the assessment proceedings, the Transfer Pricing Officer (TPO) referred to the special bench ruling in the case of LG Electronics Pvt Ltd. (supra) which has treated brand building in the local market as an international transaction.
- The TPO was of the view that the taxpayer is double jeopardised as the taxpayer is neither getting any benefit for developing the brand of the Associated Enterprise (AE) nor allowed to create its own brand and logo.
- The TPO then noted that the taxpayer had the brand value of Hyundai as evident from the 'interbrand' valuation which shows that the brand value of Hyundai increased from INR4.5 billion to INR4.7 billion in 2007 to 2008.
- The TPO raised the following questions for discussion
  - If the holding company is not being benefitted by brand development, then why it has been made a mandatory requirement in the agreement?
  - If the use of brand in all the vehicles benefits only the taxpayer's company, what is the reason behind the charitable purpose of the holding company to use the existing popular brand?
- In light of the above the Assessing Officer (AO) proposed an adjustment of INR198.66 crore for AY 2009-10. Aggrieved by the order, the taxpayer filed grounds of objections before the Dispute Resolution Panel (DRP).

[1] Hyundai Motor India Limited v. DCIT (ITA No. 853/Chny/2014 and 563/Chny/2015)
[2] LG Electronics Pvt Ltd v. ACIT [(2013) 22 ITR 1 (DEL) (Trib)]

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- While the DRP thus upheld the arm's length price (ALP) adjustment in principle, the quantum of adjustment was scaled down in the sense that as against the share in global sales, in terms of quantity of cars sold, the DRP adopted the share in global sales, in terms of value of cars sold. This variation in the mechanism of allocating contribution to global brand value resulted in the reduction of ALP adjustment to INR54.15 crore for AY 2009-10.

- The AO adopted the average of the brand value as per Interbrand and Milward Brown Optimor and proposed an adjustment of INR62.20 crore for AY 2010-11 which was upheld by the DRP.

- For AY 2011-12, the TPO adopted Spearman's rank correlation coefficient on the basis of interbrand valuation which resulted in an adjustment of INR253.43 crore which was upheld by the DRP.

Tax Department's contentions

- The tax department referred to the special bench ruling, in the case of LG Electronics Pvt Ltd (supra) where it was concluded that excess of Advertisement, Marketing and Promotion (AMP) expenditure over and above the bright-line, constitutes a transaction between the Indian taxpayer and the foreign AE for promotion of brand of AE in India. Considering the same, the tax department construed that the taxpayer therefore faulted for not having benchmarked the international transactions relating to brand development.

- The tax department also referred to paragraph 1.42 of the OECD's TP Guidelines, and adopted the Comparable Uncontrolled Price method to benchmark the transaction relating to brand building separately instead of aggregating the same under Transactional Net Margin Method.

- The tax department contended that no unrelated entity would enter into such an arrangement which would benefit one party and make the other party vulnerable and that any unrelated entity would indulge in creating and promoting its own brand so that the brand owned by it gets developed over a period of time and helps in capturing domestic market as well as global market.

- The tax department also set out the TPO's analysis about the virtues of emerging Indian automobile market presence which ensures that even in case of downfall in global market, HMC will not suffer. Hyundai is a very important player in the Indian car market and this is to a very large extent due to the efforts by the taxpayer that the brand name 'Hyundai' has become an intangible asset in India.

- Tax department also by referring Section 92B of the Income Tax Act, 1961 (the Act) explained that TP provisions shall be applicable on all international transactions irrespective of the fact whether it has any bearing on the profit, income or losses or not. In addition to this, the capital/debt financing has also been included in the definition of international transaction. This amendment has been proposed with retrospective effect from AY2002-03. Therefore brand development by the taxpayer should also be construed as an international transaction.

Taxpayer's contention

- The taxpayer pleaded that it has not rendered any brand building service and there was no brand promotion activity carried out by the taxpayer in the absence of which there was no requirement to compensate the taxpayer.

- The taxpayer also highlighted the fact that the taxpayer and HMC have not entered into any contract for brand building services and that if there is no such arrangement, the holding company cannot be said to have benefited at the expense of the taxpayer and, as such, the taxpayer is not entitled to any compensation.

- The taxpayer also highlighted that the taxpayer is the economic owner of the brand in India and the taxpayer has not incurred any brand related expenses for the development of brand Hyundai.

- The taxpayer further highlighted that it satisfied the bright line test, i.e. AMP expenses spent by the taxpayer as a proportion of net sales is not an unreasonable high figure and there is no excess over and above the market benchmark average.

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- The taxpayer submitted that brand building service even if that be so, is at best a notional income which cannot be brought to tax and also is not an international transaction as per the definition prescribed under Section 92B of the Act.

Tribunal's ruling

After hearing both the parties, the Tribunal held the following:

- There is a clear difference between LG and the taxpayer's case, as it is an undisputed position that the percentage of AMP expenses as a proportion of net sales is not an unreasonable high figure and that the arguments of the taxpayer that there is no excess over and above a market benchmark average in the relevant financial year is accepted.

- Further, the Tribunal stated that in the present case, the emphasis is all along on the benefit accruing to the parent company, on account of increased brand valuation, as a result of cars being sold by the taxpayer company in India, and not as a result of conscious brand promotion by the taxpayer.

- The trigger for the impugned ALP adjustment is not the expense incurred by the taxpayer or any efforts made by the taxpayer, for brand building for its principal, but the mere fact of the sale of cars made by the taxpayer. No services are thus rendered by the taxpayer, unlike, for example, in LG's case where brand building was due to conscious and focused efforts of the Indian company to do so.

- The Tribunal also emphasized on the fact that if the taxpayer, instead of using 'Hyundai' in the name of each of its brand of cars manufactured, was to use a name owned by the taxpayer, the advantage of adding value to a brand, as a result of sale of cars manufactured by the taxpayer, would have gone to the taxpayer, rather than going to the AE. It is this arrangement, for the benefit of the AE, which is stated to be international transaction.

- The Tribunal brought out two basic aspects of this arrangement being an international transaction- first, what is the true nature, and proximate cause, of this arrangement about the use of foreign brand name- is it a case of using foreign brand name to promote the brand name, or to benefit from the reputation of such a brand name; and- second, what is the scope of definition of 'international transaction' under the Indian TP legislation, and whether this arrangement fits into the same.

- The Tribunal also stated the fact that the use of brand name, owned by the AE, in the motor vehicles manufactured by the taxpayer does amount to a benefit to the AE of the taxpayer, an incidental benefit though, in the sense that increased visibility to this trade name does contribute to increase in brand valuation of the brand name. The question really is whether such an incidental benefit to the AE, even if there be any, can be treated as an international transaction under the Indian TP legislation.

- The Tribunal referred to the definition of international transaction under section 92B of the Act and stated that as for intangibles are concerned, the definition of international transactions, includes only transactions of purchase, sale or lease of intangible properties.

- The Tribunal opined that though, 'provision for services' is included in the definition of 'international transaction' under Section 92B of the Act, accretion in brand value due to use of foreign AEs brand name in the name of taxpayer's products cannot be treated as service either.

- In any event, the Tribunal held that a service has to be a conscious activity and it cannot be a subliminal exercise as is the impact on brand value in this case. A passive exercise cannot be defined as a service. Every benefit accruing to an AE, as a result of dealing with another AE, is not on account of service by the other AE. What is benchmarked is not the accrual of 'benefit' but rendition of 'service'.

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All benefits are not accounts or services by someone, just as all services do not result in benefits to the parties. The expressions 'benefit' and 'service' have different connotations, and what is truly relevant, for the purpose of definition of 'international transaction' in Indian context, is 'service'- not the benefit. There is no rendition of service in the present context.

- Based on discussions in the OECD Guidelines just to highlight the fact that even in situations in which benefit test is specifically set out in the definition of international transaction, the determination of arm's length price of a service has two components- first, of rendition of service; and- second, of benefit accruing from such services. When the first condition is not satisfied, as in the present case, the matter rests there, and there is no question of benchmarking the benefit in isolation. The Tribunal held that incidental benefit accruing to an AE, therefore, cannot be benchmarked unless it is the result of a specific service by the taxpayer.

- The Tribunal held that the accretion in brand value of the AE's brand name is not on account of costs incurred by the taxpayer, or even by its conscious efforts, and it does not result in impact on income, expenditure, losses or assets of the taxpayer. It is not, therefore, covered by the residuary component of definition of 'international transaction' either.

- Considering the above, the Tribunal held that the accretion of brand value, as a result of use of the brand name of foreign AE under the technology use agreement- which has been accepted to be an arrangement at an arm's length price, does not result in a separate international transaction to be benchmarked and therefore, deleted the impugned adjustments.

Our comments

The Tribunal has clearly brought out the difference between the taxpayer's case and the rulings by Tribunal and High court in the case of LG Electronics, Sony Ericsson[3], Maruti Suzuki[4] etc.

The Tribunal has done a threadbare analysis of the definition of international transaction as per Section 92B of the Act and categorically held that the brand value accretion does not fall under the said definition.

The Tribunal held that brand value as a result of use of brand under the technology use agreement does not result in a separate international transaction which needs to be benchmarked.

[3] Sony Ericsson Mobile Communications India Pvt Ltd vs CIT [(2015) 374 ITR 118 (Del)]
[4] Maruti Suzuki India Ltd Vs ADIT [(2010) 328 ITR 510 (Del)]

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