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High Court rules a foreign entity to pay royalty to an associated domestic entity for brand promotion if the domestic entity has an obligation to use foreign brand on its products

Executive Summary

This alert summarizes the recent ruling of Delhi High Court (HC) bearing reference [W.P. (C) 6876/2008] in the case of **Maruti Suzuki India Ltd** (Taxpayer) on determination of arms length price (ALP) of a transaction with an associated enterprise for use of trademark/ logo (brand) pursuant to Transfer Pricing (TP) regulations under the Indian Income Tax Act [ITA]. The Taxpayer, pursuant to a licence agreement, collaborated with Suzuki Corporation of Japan [Suzuki] for supply of automotive components, spare parts etc. along with complete technical know how for manufacture of motor cars. The agreement included a condition that the front side of the vehicle must bear the logo **'S'** and on the back side of the vehicle the name 'Maruti' and 'Suzuki' must appear. The Taxpayer was required to pay royalty to Suzuki at the prescribed rate on sales turnover. As per TP regulations under the ITA, Tax Authority has power to enhance the taxable income of a Taxpayer in respect of a transaction with a non resident which is an associated enterprise (AE) if in its opinion the transaction is not made at ALP. In the instant case, the Tax Authority contended that Maruti was an established brand in India even prior to its technical collaboration with Suzuki and by virtue of co branding of Maruti Suzuki, the Suzuki in fact benefited in terms of enhancement of its brand value out of the heavy advertisement expenditure incurred by the Taxpayer, the ground on which the Tax Authority enhanced the taxable income of the Taxpayer for an amount of INR 99.33 crores as and by way of royalty - which in its opinion should have been charged by the Taxpayer to Suzuki on account of mandatory use of Suzuki brand on the products manufactured and marketed by the Taxpayer. The Taxpayer's contention was that in the notice issued by the Tax Authority, the issue of benefit accruing to Suzuki on account of co branding was never confronted and therefore the entire proceeding was liable to be quashed as illegal for want of natural justice. The HC agreed with the contention that the assessment proceeding was devoid of natural justice and set aside the enhancement of taxable income. Additionally, the HC laid down in principle guidelines for charge of royalty by a domestic entity in case of transaction with an associated foreign enterprise for the use of brand. The HC laid down that ordinarily, a domestic entity is not required to charge royalty to foreign entity for use of a foreign brand, if use of the brand is at the discretion of the domestic entity. However, in a scenario where the use of the foreign brand on the products and packaging of the domestic entity is made mandatory by the foreign entity, then it should have paid royalty to the domestic entity towards the benefit which accrues to it by way of

enhancement of the foreign brand in the domestic territory.

Background

As per TP regulations under the ITA, the Tax Authority is empowered to enhance taxable income of a Taxpayer in a case where its transaction with non resident associated enterprise is not effected at ALP. In the instant case, the Taxpayer established its business in the year 1983 as manufacturer of motor cars under the brand name Maruti. To meet with market competition and launch new products it entered into collaboration with Suzuki in the year 1992. As per the agreement, the Suzuki was required to provide complete technical know how and assistance for manufacturing activities and also provide support for marketing for the consideration of royalty payment by the Taxpayer. Significantly, the agreement also provided that the trade mark 'S' (Suzuki) must appear on the front side of the vehicle and on the back side the vehicle, the name Maruti and Suzuki must appear. Taxpayer was also required to manufacture the motor vehicles for exports out of India which would bear the trade mark 'Suzuki' alone. However on such export sales too the Taxpayer was required to pay royalty referred to above. The Taxpayer had incurred heavy expenditure on advertisements without any reimbursements by Suzuki. In the above factual matrix, the Tax Authority took the view that:

- In domestic market, Maruti was an established superior brand than Suzuki.
- Since Suzuki was also the shareholder of the Taxpayer, it was an associated enterprise, the transactions with whom, if not made at ALP, an appropriate enhancement to the income of the Taxpayer is required to be made.
- Suzuki has derived the advantage of promoting its brand in India by virtue of co-branding condition in the collaboration agreement and also benefited in terms of higher dividend and shareholders value out of the increased sales turnover of the Taxpayer.
- Suzuki ought to have paid royalty to the Taxpayer who had incurred heavy advertisement expenditure towards promotion of the Suzuki brand in India. Accordingly it made enhancement of INR 99.33 crores to the taxable income of the Taxpayer.

  The Taxpayer took the position that at no stage of proceedings the Tax Authority raised the issue of royalty payment by Suzuki to it and therefore had no opportunity to present its side as to how the enhancement to its income was not justified. The Taxpayer filed writ petition with the HC with the prayer to quash the assessment order on the ground of illegality of the proceedings and the merits of the case.

Taxpayer's contentions

- The basis adopted for TP adjustments resulting into enhancement of taxable income was not confronted to it and therefore the assessment proceedings being bad in law, the order should be quashed.
- On merits, Suzuki, to protect its shareholding value against the strong competition emerging from entry of other multi national car manufacturers in India, permitted use of the 'Suzuki' brand to the Taxpayer to meet with the competition. Suzuki has not charged any additional consideration for use of its brand.

Tax authority's Contentions

- Merits of the Transfer Pricing adjustments cannot be examined in a writ petition since alternative remedy of

appeal before the appellate authority was available to the Taxpayer

- It was evident from the collaboration agreement that the Taxpayer was responsible for market development and promotion of the trade marks 'Maruti', 'Maruti Suzuki' and 'Suzuki' for which it incurred huge expenditure on advertisement and for which no reimbursement was received from Suzuki.
- Out of the total royalty paid to Suzuki, amount attributable to co branded trade mark 'Maruti Suzuki' and the trade mark 'Suzuki' can not be allowed as expense in the assessment of the Taxpayer because brand 'Maruti' was stronger in India than the brand 'Suzuki'.
- Co branding of the Suzuki trade mark had resulted into migration of economic value of the stronger brand Maruti to weaker brand Suzuki, for which no compensation was paid to the Taxpayer.
- No independent entity would undertake brand promotion of another entity at its own expense without any compensation from that other entity.
- Out of the total royalty of INR 198.60 crores, for the want of bifurcation between the royalty amount attributable to licence for manufacture and the amount attributable to the use of 'Suzuki' brand; fifty percent of the total amount i.e. INR 99.33 crores be apportioned towards the use of the co branded trade marks which amount cannot be allowed as expenditure since the brand 'Maruti' was stronger than the brand 'Suzuki'.
- The Taxpayer has incurred non routine advertisement expenditure of INR 107.22 crores which was attributable to the development of the brand Suzuki and hence the same cannot be allowed as expenditure.
- In all taxable income of the Taxpayer be enhanced by INR 206.52 crores

High Court's observations

- A contention that in every case where domestic associate enterprise is allowed to use foreign trade mark, the foreign entity must pay royalty, regardless of, whether the use of trade mark is obligatory or not, is not acceptable because acceptance of that contention would keep foreign entities away from collaborating with domestic entities.
- However, in the instant case, the Taxpayer is under a contractual obligation to use the 'Suzuki' trademark. Compulsory use of the trademark even when the domestic entity does not require it indicates benefit to the foreign entity in the form of brand building in the domestic market. If the agreement between two entities which are associated enterprises carries an obligation to use joint trademark, then appropriate consideration must flow in favour of the enterprise which is under an obligation to use trademark of the other entity jointly.
- Domestic entity which uses the foreign trademark, on its own discretion, may incur advertisement expenditure for promotion of the products bearing brand of the foreign entity, it is not necessary that the foreign entity must compensate the domestic entity for such expenses.

High Court's guidance

The HC opined that the Transfer Pricing provisions being rather new to tax regime in India and with the increased presence of multinationals in India, these provisions are likely to come up frequently for

application by the Tax authorities, it is desirable to explain the scope of powers of the Tax Authority, procedure to be followed and approach to be adopted while dealing with the cases which require deliberation on issues considered in the instant case. The HC laid down the following guidance:

- Primarily, it is for the Taxpayer to establish that he has computed ALP in consonance with ITA. The Tax Authority may reject the computed price only where it finds that the Taxpayer has failed to substantiate the computation or has used defective data or it finds evidence which proves defect in the credentials of data or the method followed by the Taxpayer.
- The Tax Authority must give adequate opportunity, by a notice, to enable the Taxpayer to support ALP computed by him. If the Tax Authority proposes to make adjustments to ALP computed by the Taxpayer, it must issue a notice conveying the ground for the proposed adjustments and also give opportunity to produce evidence to controvert those grounds.
- In a case where the domestic entity and the foreign entity are associated enterprises, payment of royalty by the entity whose brand is used by the other entity on its products and packaging is not necessary, provided the use of the foreign brand is at the discretion of the domestic entity. However, if it is mandatory for the domestic entity to use the foreign brand, the foreign entity must make appropriate payment towards the benefit derived by it in the form of marketing intangibles.
- Even in the cases where payment is to be made by the foreign entity, to the domestic entity as the aforesaid, the ALP in respect of the income from the international transaction between the two entities be determined, taking into consideration all the rights obtained and obligations incurred by the parties under the international transaction in question, including the value of marketing intangibles obtained by the foreign entity on account of compulsory use of its brand by the domestic entity. Suitable adjustments in this regards will have to be made considering the individual profiles of these entities and other facts and circumstances justifying such adjustments.
- The foreign entity need not compensate the domestic entity towards the expenditure incurred by the later on advertising, promotion and marketing of its products using the foreign brand so long as the expenses incurred by the domestic entity do not exceed the expenses which a similarly situated and comparable independent domestic entity would have incurred. However, if the expenses so incurred by a domestic entity are more than what a similarly situated and comparable independent domestic entity would have incurred, the foreign entity must suitably compensate for the advantage obtained by it in the form of brand promotion.
- In case the foreign entity is liable to compensate as stated above, the Tax Authority shall determine the ALP in respect of the international transaction taking into consideration all the rights obtained and obligations incurred by the two entities, including the advantage obtained by the foreign entity.

High Court ruling

- The Tax Authority has passed the order for enhancement of income without evidence which is an error of law.
- The Tax Authority followed the faulty procedure, adopted erroneous approach and pass the order which is arbitrary and irrational. Hence, regardless of the alternative remedy of

appeal under the ITA available to the Taxpayer, it is open to the court to set aside the order passed by the Tax Authority in exercise of writ jurisdiction under Article 226 of the constitution. Accordingly the order is set aside. However guidelines are being laid down for reference of the Tax authorities to follow in the matter of determination of ALP in the case of user by a domestic entity of intangible assets such as brand of the associated foreign entity. The Tax Authority is directed to pass fresh order in the case of Taxpayer in the light of court's observations and the aforesaid guidelines.

Our comments

In respect of transaction between a domestic entity and foreign entity which are associated enterprises, it is necessary that the domestic entity pursuant to the ITA maintains adequate documentation and establish that its transaction with the foreign entity is at ALP. If the Tax Authority is not satisfied on the computation of ALP by the Taxpayer, it has the power to make appropriate adjustments to enhance the taxable income for the relevant year.

The Transfer pricing provisions were introduced in the ITA from the year 2001. Since then, there are huge tax litigations pending disposal at various stages of proceedings. By now, especially in respect of determination of ALP for transaction involving intangibles, not enough material is available in terms of tax jurisprudence that can be relied upon by the Taxpayer and the Tax authorities as well. This ruling throws light on conceptual framework to determine ALP when a domestic entity makes use of the foreign brand in a scenario where the concerned entities are the associated enterprises. The HC has amply clarified that the principles enunciated in this ruling would apply only in the case of transaction between a domestic entity and a foreign entity which are associated enterprises in terms of ITA, and not otherwise.

The HC laid down that adequate opportunity should be available to Taxpayer to present its case, should the Tax Authority propose to make adjustment to the transaction value between the associated enterprises before making enhancement of income of the domestic entity. Significantly, it is laid down that if the use of foreign brand by the domestic company on its products and packaging is mandatory, rather than discretionary, as it should normally be, it is possible to draw an inference that the foreign entity has the intention to promote its brand in the jurisdiction of the domestic entity and therefore it must pay appropriate royalty to the domestic entity towards the benefit derived in terms of promotion of its own brand in the domestic jurisdiction. It is also laid down that if the advertisement expenditure incurred by the domestic entity for the marketing of its product is not more than such expenditure incurred by a comparable independent domestic entity, then no adjustment is warranted. However in the other scenario, the appropriate amount of expenditure on advertisement may be attributable to the promotion of the foreign brand and therefore unless the domestic entity has been compensated by the foreign entity in this regard, the Transfer pricing adjustment may be necessary.

This ruling emphasis the appropriate drafting of the agreement with the foreign collaborator to bring out succinctly the intention and commercial understanding between the parties to the agreement.

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