An Analysis of the Case Kellogg India Private Limited vs. India

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Abstract
The present article analyzes the Mumbai Income Tax Appellate Tribunal's judgment in case No. ITA No. 7342/Mum/2018, involving Kellogg India and the State. Initially, it provides a brief definition of transfer pricing and outlines the tests applicable to intra-group transactions. Subsequently, it examines the methods applied by Kellogg India and the method determined by the Tax Authority, as well as the decision made by the Mumbai Income Tax Appellate Tribunal. Lastly, it will analyze whether the case's resolution is in line with the OECD Transfer Pricing Guidelines. This study seeks to conclude how to proceed in cases where there is the possibility of applying more than one transfer pricing method.
Keywords: Transfer pricing, evaluation methods, Brazil, India.

1. Introduction

As is well known, transfer pricing is one of the most important topics when it comes to international tax law. In a global economy where multinational enterprises are growing on a large scale, governments need to ensure that the taxable profits of those enterprises are not being artificially shifted to other jurisdictions.

This article gives a brief introduction to the nuanced process of identifying and delineating transactions within the framework of transfer pricing, offering an approach to applying transfer pricing methods in line with the OECD Guidelines. The foundational principle guiding this examination is the arm's length principle, which mandates that transactions between related parties should be priced as if they were conducted between independent entities under comparable circumstances. This principle ensures that the economic reality of each transaction is accurately reflected, promoting fairness and compliance with international standards.

To provide a thorough understanding, we will first introduce and explain the traditional transactional transfer pricing methods, which include the Comparable Uncontrolled Price (CUP) method, the Resale Price Method (RPM), and the

Cost-Plus Method (CPM). Each of these methods has distinct applications and is chosen based on the nature of the transaction and the availability of reliable data. We will then transition to discussing transactional profit methods, such as the Profit Split Method (TPSM) and the Transactional Net Margin Method (TNMM), which focus on the distribution of profits based on the relative contributions of the parties involved. By analyzing these methods, we aim to establish a solid foundation for evaluating the tribunal's decision in Case No. ITA No. 7342/Mum/2018.

In examining the specifics of this case, the article will address whether the tribunal's decision was assertive and justified under the applicable transfer pricing methods. We will also consider the perspectives of Kellogg India and tax authorities, providing insights into how their respective views influenced the case. By comparing the application of these methods to the facts of the case, we will assess the robustness of the tribunal's conclusions and their alignment with established transfer pricing practices. This comprehensive analysis will shed light on the practical implications of transfer pricing decisions and their impact on multinational operations.

2. Brief Introduction to Fundamentals of Transfer Pricing

2.1. Transfer pricing overview

In a short explanation, transfer pricing refers to the amount charged by a company in the sale or transfer of goods, services, or intangible property to a related company. As well explained by Raffaele Petruzzi, Giammarco Cottani, Stig Sollund and Sayee Prasanna transfer pricing is about the price arrangements set by individual entities within multinational enterprises in the transfer of those goods, services, or intangibles most known in the practice of the market as "intra-group" transactions.[1]

Those prices must be overseen by the tax authorities to prevent taxpayers from engaging in artificial pricing concerning the free market, thereby creating inflated expenses or diminished revenues, to reduce their tax base. In other words, it ensures that expenses exceeding the limit set by the transfer pricing rule are not deductible and non-recognized revenues are taxed.

In today's global tax landscape, the arm's length principle stands as the cornerstone for apportioning business income among related parties situated in different jurisdictions. This principle is universally embraced by the majority of countries worldwide as the fundamental criterion for determining fair and equitable allocation of taxable profits in cross-border transactions. Its application ensures that transactions between related entities are assessed as if they were be-

[1] PETRUZZI, Raffael; COTTANI, Giammarco; SOLLUND, Stig; PRASANNA, Sayee. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 1: Introduction to Transfer Pricing, Vienna: Walters Kluwer, May 2021.

tween independent parties, thereby safeguarding against potential tax base erosion and ensuring consistency in international tax practices.

The basis of the arm's length principle is essential to ensure equivalent tax treatment between transactions involving related and unrelated parties, such that the allocation of taxable profits reflects conditions comparable to those that would occur between independent parties under normal circumstances of assuming risks and performing functions within enterprises.[2]

According to Adriano Luiz Batista Messias, the Organization for Economic Co-operation and Development (OECD) has adopted a standard for applying transfer pricing methods among related enterprises known as the arm's length principle, derived from the concept of treating related entities within the same multinational group as independent entities, following the principle of equality.[3]

However, the implementation of the arm's length principle is widely acknowledged to pose significant challenges, resulting in a considerable administrative burden for both taxpayers and tax authorities. To address these challenges, a frequently proposed alternative to the arm's length principle is the adoption of a global formulary apportionment system. Under this approach, the profits of a multinational enterprise would be allocated among different countries by: (a) establishing a unified taxable base; and (b) distributing this base using a formula that considers various production factors such as revenues, assets, and human capital.[4]

It is crucial to emphasize that the purpose of transfer pricing is to ensure that transactions between related companies are conducted at market value, with the arm's length principle. If these transactions are not aligned with market values, it violates the constitutional principles of tax equity and fairness, as it undermines the ability to pay and equality among taxpayers. This alignment is essential to ensure that all entities are taxed appropriately and equitably, maintaining the integrity of the tax system.[5]

In conclusion, transfer pricing regulates the pricing of goods, services, or intangible assets exchanged between related entities within multinational enter-

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[2] OECD (2022). OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022. Paris: OECD Publishing. Available in: https://www.oecd.org/en/publications/2022/01/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_57104b3a.html. Accessed in 17 July 2024.

[3] MESSIAS, Adriano Luiz Batista. *Preços de transferência no planejamento tributário internacional – perspectiva sob a ótica da teoria das provas.* Revista Direito Tributário Internacional Atual vol. 9, ano 5. São Paulo: IBDT, 1º semestre 2021, p. 36-70.

[4] PETRUZZI, Raffael; COTTANI, Giammarco; SOLLUND, Stig; PRASANNA, Sayee. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 1: Introduction to Transfer Pricing, Vienna: Walters Kluwer, May 2021.

[5] Cf. SCHOUERI, Luís Eduardo. "*Aplicação concomitante da legislação de preços de transferência e da tributação do lucro em bases mundiais*". In: TÔRRES, Heleno Taveira (coordenador). Direito Tributário Internacional aplicado. V. 3. São Paulo: Quartier Latin, 2005, p. 244.

prises, crucially impacting tax liabilities. The arm's length principle, widely endorsed globally, ensures fairness in allocating taxable profits across borders by treating related parties as independent entities. However, its implementation presents substantial challenges, burdening both taxpayers and tax authorities. To mitigate these issues, the concept of global formulary apportionment has been proposed as an alternative, aiming to allocate multinational enterprise profits among countries based on a unified taxable base and a formula considering various production factors. This approach seeks to enhance transparency and equity in international tax practices amid complex global business environments.

2.2. The identification of commercial or financial relations and the delineation of the transactions

The initial phase in delineating the actual transaction involves identifying the commercial or financial relationships between the related parties involved in the transaction. This necessitates a preliminary understanding of the industry sector in which the multinational enterprise operates, as well as an appreciation of the various factors that influence the performance of businesses within that sector.

A Global Value Chain Analysis (GVCA) serves as the foundation for this process. This analysis is instrumental in determining how economic value is generated within the multinational enterprise and in aligning the expected transfer pricing outcomes accordingly.

To accurately delineate an actual transaction by identifying the commercial or financial relations, it is crucial to determine whether unrelated parties, under comparable circumstances, would and could engage in the transaction as delineated. The core principle of an arm's length analysis is that unrelated parties act rationally, considering the options realistically available (ORA) before concluding transactions. In specific and exceptional circumstances, an accurately delineated actual transaction may be disregarded or replaced if the intra-group arrangements, when viewed as a whole, differ from those that unrelated parties would adopt in a commercially rational manner under similar conditions.[6]

As well pointed out by Sayee Prasanna & Dorottya Kovács, the comparability analysis involves comparing transactions between related parties to those between unrelated parties. Transactions are considered comparable if any differences between them do not significantly affect the prices, profits, or margins being analyzed. This analysis is critical to determining whether the terms of a related party transaction reflect the arm's length principle. It ensures that related party trans-

[6] PETRUZZI, Raffael; COTTANI, Giammarco; SOLLUND, Stig; PRASANNA, Sayee. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 1: Introduction to Transfer Pricing, Vienna: Walters Kluwer, May 2021.

actions are conducted under terms and conditions similar to those that would be agreed upon by independent entities in similar circumstances.[7]

In the view of Sayee Prasanna and Raffaele Petruzzi, the 1995 OECD Transfer Pricing Guidelines introduced essential components for accurately identifying commercial or financial relations, with detailed provisions on comparability that highlighted five key factors: contractual terms, functional analysis, characteristics of property or services, economic circumstances, and business strategies. These factors, recognized by most countries, form the foundational basis for the current process of identifying commercial or financial relations.[8]

The contractual terms are the starting point for a comparability analysis. Along with the functional analysis, it is important to identify the legal clauses in the written agreements that guide the functions performed and evaluate the intention of the parties, assets used, and risks assumed by the transacting parties.

In conclusion, a meticulous approach to identifying and applying transfer pricing methods, guided by the foundational principles outlined in the OECD Guidelines, is indispensable for ensuring compliance with the arm's length principle. This approach not only withstands the scrutiny of tax authorities but also ensures that multinational enterprises operate in a commercially rational manner, aligning their internal procedures with industry's best practices. By adhering to these guidelines, MNEs can achieve a consistent, coherent, and legally sound transfer pricing policy.

2.3. The transfer pricing methods

Once a transaction has been accurately delineated and recognized, selecting the most appropriate transfer pricing method to determine the arm's length remuneration is essential. The available transfer pricing methods are typically categorized into two groups: (a) traditional transactional methods and (b) transactional profit methods. This selection ensures that the transaction's pricing reflects what unrelated parties would agree upon under similar circumstances.[9]

As a general introduction to traditional and transactional profit methods, it is important to understand that these methods are used to test or establish whether the conditions of the tested transactions meet the arm's length standard. This means ensuring that the terms and prices of transactions between related parties

[7] PRASANNA, Sayee; KOVÁCS, Dorottya. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 5: Comparability Analysis, Vienna: Walters Kluwer, May 2021.

[8] PETRUZZI, Raffael; PRASANNA, Sayee. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 2: Accurate Delineation and Recognition of Actual Transactions, Vienna: Walters Kluwer, May 2021.

[9] PETRUZZI, Raffael; COTTANI, Giammarco; SOLLUND, Stig; PRASANNA, Sayee. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 1: Introduction to Transfer Pricing, Vienna: Walters Kluwer, May 2021.

are consistent with those that would be agreed upon by unrelated parties under similar circumstances.

The transfer pricing method selected must be the most appropriate method for the specific case. Choosing the right method is crucial, as using an inappropriate one leads to higher risks of errors and unreliable results. While there is no strict hierarchy of methods, traditional methods are generally preferred when they can be applied as reliably as transactional profit methods. Traditional transaction methods are favored because they are considered the most direct way to establish an arm's length outcome.[10]

As stated by Melinda Brown & Mauro Orlandi, to choose and apply the right transfer pricing method is crucial for multinational enterprises to establish their transfer pricing policy. Tax authorities carefully review both the selection of the method and how it is applied to ensure that the terms of the transaction meet the arm's length principle. Additionally, multinational enterprises need to implement their transfer pricing policy effectively by ensuring that internal procedures for aligning transfer prices with arm's length values are clearly communicated and consistently applied across the organization. They must also monitor these procedures regularly.[11]

Traditional Transaction Methods

The Comparable Uncontrolled Price (CUP) method compares the price charged for property or services in a tested transaction to the price charged for similar property or services in an unrelated party transaction under comparable circumstances. This method can be applied using either internal comparable transactions (within the same company) or external comparable transactions (between unrelated companies), depending on the available information.[12]

In Brian J. Arnold's view, the CUP method establishes an arm's length price by comparing sales of similar products between unrelated parties under similar circumstances. According to the 2017 OECD Guidelines, quoted commodity prices can indicate arm's length prices if transactions are comparable and the pricing date is considered. The CUP method is suitable for pricing goods that do not depend on specialized know-how or brand names, but is unsuitable for custom-made parts or goods reliant on a trade name.[13]

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[10] BROWN, Melinda; ORLANDI, Mauro. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 3: Transfer Pricing Methods: Traditional Transaction Methods, Vienna: Walters Kluwer, May 2021.

[11] BROWN, Melinda; ORLANDI, Mauro. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 3: Transfer Pricing Methods: Traditional Transaction Methods, Vienna: Walters Kluwer, May 2021.

[12] BROWN, Melinda; ORLANDI, Mauro. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 3: Transfer Pricing Methods: Traditional Transaction Methods, Vienna: Walters Kluwer, May 2021.

[13] ARNOLD, Brian J. International Tax Primer, Fifth Edition – Arnold, Chapter 6: Transfer Pricing, Amsterdam: Kluwer Law International B.V., 2023.

The Resale Price Method (RPM) determines the arm's length price for goods sold between related parties by deducting an appropriate markup from the resale price to unrelated parties. This method is typically applied when a taxpayer sells manufactured goods to a related distributor, who then resells them to unrelated customers without further processing. The appropriate markup is the gross profit percentage that distributors usually earn in similar transactions with unrelated parties.[14]

The Cost-Plus Method (CPM) starts by determining the costs incurred by the supplier for property or services in a related party transaction. To this cost, a gross profit margin, or markup, is added, which reflects what unrelated parties would typically apply. This approach helps us establish an arm's length price for the transaction. Adjustments to the markup may be necessary to account for any functional or other differences between the tested transaction and comparable transactions with unrelated parties. The CPM is especially useful for transactions involving services, semi-finished goods, or manufacturing activities, where such adjustments are often needed.[15]

Briefly the traditional methods: (i) CUP compares the price of property or services in a related party transaction with the price of similar property or services sold between unrelated parties under similar conditions; (ii) RPM compares the gross margin earned by a related party reseller with the gross margin earned by unrelated party resellers in similar transactions and (iii) CPM compares the gross markup on costs added by a related party manufacturer or service provider with the gross markup achieved by unrelated parties in similar transactions.

Transactional Profit Methods

The Transactional Net Margin Method (TNMM) is used to determine an arm's length profit by assessing the net profit margin realized in a related party transaction. This method involves calculating the net profit margin of the tested transaction relative to a chosen base, such as costs incurred, sales made, or assets employed. To ensure comparability, this net profit margin is then compared to the margin achieved in a similar transaction between unrelated parties, using the same base.

Adjustments may be necessary to account for any differences between the tested transaction and the comparable transaction that could materially affect the net profit margin. These adjustments ensure that the profit margins being compared are truly comparable and reflect similar economic conditions.

[14] ARNOLD, Brian J. International Tax Primer, Fifth Edition – Arnold, Chapter 6: Transfer Pricing,Amsterdam: Kluwer Law International B.V., 2023.

[15] BROWN, Melinda; ORLANDI, Mauro. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 3: Transfer Pricing Methods: Traditional Transaction Methods, Vienna: Walters Kluwer, May 2021.

The TNMM is particularly useful when there are significant differences in the products or functions involved in the transactions. By focusing on the net profit margin, rather than the gross margin or transaction price, the TNMM helps address complexities where traditional methods may not be applicable. This method provides a reliable measure for establishing an arm's length profit by aligning the profitability of related party transactions with that of comparable unrelated party transactions.[16]

The Profit-Split Method (TPSM) is designed to allocate the worldwide taxable income among related parties based on their contributions to earning that income. This method is particularly useful when traditional transfer pricing methods, such as the Comparable Uncontrolled Price (CUP), Resale Price Method (RPM), or Cost-Plus Method (CPM), are unsuitable due to the complexity of the transactions or the lack of comparable data. The profit-split method aggregates the profits from a group of transactions and divides this total profit among the related parties according to their respective contributions, rather than focusing on individual transaction prices.

When applied to organizations with multiple product lines or business segments, the profit-split method can be tailored to each segment to account for the different roles and risks associated with each. Unlike traditional methods, which evaluate individual transactions, the profit-split method provides a holistic approach by considering the combined profitability of related transactions. This method ensures that profits are distributed in a manner that reflects the true economic contributions and value added by each party involved in the joint business activity.[17]

In short, the TNMM is a one-sided transfer pricing method that assesses the net profit margin, after deducting direct and operating expenses, from the tested transactions and compares it to the net profit margin earned by unrelated parties in comparable transactions. In contrast, the TPSM is a two-sided approach that calculates the total relevant profits from transactions between related parties and then divides these profits between the parties based on an arm's length principle. While TNMM focuses on comparing margins to ensure they reflect market conditions, TPSM involves distributing overall profits to accurately represent each party's contribution.

For the last, alternative methods may be used only if they can be proven to be more appropriate than the established methods. Taxpayers must show that any alternative method adheres to the arm's length principle.[18]

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16 BROWN, Melinda; ORLANDI, Mauro. Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 3: Transfer Pricing Methods: Traditional Transaction Methods, Vienna: Walters Kluwer, May 2021.

17 ARNOLD, Brian J. International Tax Primer, Fifth Edition – Arnold, Chapter 6: Transfer Pricing,Amsterdam: Kluwer Law International B.V., 2023.

18 BROWN, Melinda; ORLANDI, Mauro. Fundamentals of Transfer Pricing: General Topics and

2.4. The applicability of more than one method

In the selection of the most appropriate method, in some situations when determining the arm's length price, it is often possible to derive the result using more than one prescribed transfer pricing method. In such cases, it is advisable to select and apply the method deemed most appropriate based on the specific circumstances of the transaction. This decision should consider factors such as the nature of the transaction, the availability and reliability of comparable data, and the overall alignment with the arm's length principle.

For example, in a scenario where a company acts as a limited-risk distributor purchasing finished goods from a related manufacturer and reselling them without any significant value addition, the RPM is typically the most appropriate method. RPM focuses on the gross margin and is suitable when the reseller performs standard functions such as warehousing, sales, and marketing without developing or using unique intangibles.

Conversely, in a situation where a company provides complex services, such as contract research and development or high-value consulting, to its foreign affiliate, where operating costs and risks are more difficult to isolate at the gross margin level, the TNMM often becomes more appropriate. TNMM allows for comparison at the net profit level, which is more practical when reliable gross margin data from independent comparables is unavailable.

Another instance involves intercompany loans, where the CUP method may be preferred, since it is often possible to obtain interest rates on similar third-party loans as reliable benchmarks. In contrast, CUP may not be suitable in cases involving the transfer of unique intangibles, where the Profit Split Method might be more appropriate due to the difficulty in finding comparable uncontrolled transactions and the need to allocate profits based on the parties' contributions.

However, there are instances where applying multiple methods can serve as a robust approach to demonstrate compliance with the arm's length standard. When appropriate, using different methods can provide a more comprehensive view and support the validity of the transfer pricing result. This approach can be particularly useful in complex situations where no single method fully captures the economic realities of the transaction. Therefore, while selecting the most suitable method is key, presenting results from multiple methods can strengthen the evidence supporting the arm's length outcome when justified by the circumstances.

In the past, the American transfer pricing system could only apply one method for each case following a hierarchy.[19] Now, the American system has indeed undergone a significant evolution by adopting the "best method" rule in-

Specific Transactions, Chapter 3: Transfer Pricing Methods: Traditional Transaction Methods, Vienna: Walters Kluwer, May 2021.

19 Cf. GUERARD, Laurent P. "Selecting the Best Method: a Primer", Tax Management Transfer Pricing. Special Report n. 12, vol. 4, Report n. 128, 18 October 1995.

stead of following a rigid sequential standard. This approach allows for greater flexibility in choosing the most appropriate method to evaluate a specific transaction. The idea is that by understanding the type of transaction in question, one can apply the method that most accurately reflects market conditions.[20]

As noted by Luís Eduardo Schoueri, "the existence of multiple methods for determining the arm's length price raises the question of whether there is a hierarchy among them, which is characterized by two distinct positions." It highlights that this issue revolves around understanding if there is a preferred order of methods. In practice, this means evaluating whether one method should be prioritized over others when determining the arm's length price, and how this hierarchy impacts the application of transfer pricing rules.[21]

Patrick Cauwenbergh states that the search for the "best method" does not always require a meticulous analysis of all possible methods. This is because the nature of the available data often points to one method as more reliable. In many cases, the available data indicates which method can be considered suitable for the analysis. Thus, this guidance helps to simplify the selection process, avoiding the need for a detailed evaluation of each method individually.[22]

In conclusion, sometimes more than one method can be applied to a specific case, but it has to take into account a nuanced approach, balancing methodological rigor with practical considerations of data availability and reliability. While the "best method" rule offers valuable flexibility, it also demands careful judgment and expertise in selecting and applying transfer pricing methods. Understanding when and how to employ multiple methods to substantiate results further underscores the importance of a strategic and informed approach to transfer pricing.

3. The Case Kellogg India versus Mumbai

3.1. Understanding the case and the operation

The Kellogg India case (ITA No. 7342/Mum/2018) serves as a clear illustration of how taxpayers should assess and justify the selection of the most appropriate transfer pricing method when multiple methods appear applicable, emphasizing the need to align the choice with the functional profile of the parties, the nature of the transaction, and the reliability of available data.[23]

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[20] Cf. HORST, Thomas O. "Transfer Pricing in the United States", The Tas Treatment of Transfer Pricing, Amsterdã: International Bureau of Fiscal Documentation, folhas soltas, Suplemento n. 12, November 1993, pp. United States 14-15.

[21] SCHOUERI, Luís Eduardo. *Preços de transferência no direito tributário brasileiro*. 3. ed. rev. e atual. São Paulo: Dialética, 2013. P.103.

[22] Cf. CAUWENBERGH, Patrick. "Does the Arm's Length Standard Require a Flexible or Rigid Interpretation?", International Transfer Pricing Journal n. 3, vol. 4, May/June 1997, p. 139.

[23] INDIA. India v. Kellogg India Private Limited (Case No ITA n. 7342/Mum/2018). Tax Appellate Tribunal. India: Mumbai, 2022. Available in: <https://tpcases.com/india-vs-kellogg-india-private-

Kellogg India, a subsidiary of a multinational corporation, operates in the manufacture and sale of cereals and other food products under a licensing agreement with its foreign-associated entity. The tax dispute under examination arose from the fiscal year 2014-2015.

In 2014, Kellogg India embarked on a strategic expansion by launching a new distribution business for Pringles products within the Indian market. This involved importing these products from AE Pringles International Operations SARL, commonly referred to as "Pringles Singapore," which is headquartered in Singapore. This initiative marked a significant development in Kellogg India's operational scope, leveraging global supply chains to enhance its presence in India. The move underscores the complexities of international trade and transfer pricing arrangements that arise when a subsidiary sources products from an associated foreign entity.

Pringles Singapore did not directly manufacture the Pringles products. Instead, it sourced them from a third-party manufacturer. Subsequently, Pringles Singapore transferred these products to Kellogg India, applying a 5% markup over the third-party manufacturer's cost. Kellogg India then took on the role of distributing the Pringles products within the Indian market. This arrangement highlights the intricate transfer pricing dynamics at play, where intercompany transactions and markups must be carefully analyzed to ensure compliance with the arm's length principle.

Then, Kellogg India undertook a comprehensive survey involving approximately 14 companies within the Asia-Pacific region to identify potential manufacturers. In this process, Pringles Singapore was selected as the tested party due to its status as the least complex entity. This designation was crucial for benchmarking the international transactions involving the importation of finished products. Such an approach exemplifies the strategic selection process in transfer pricing analyses, where entities are evaluated based on complexity to ensure accurate and reliable comparisons.

In the view of the tax authorities, they asserted that Kellogg India had breached the Arm's Length Price (ALP) principle in its handling of adjustments related to advertising, marketing, and promotion expenses. Additionally, the authority contended that the method employed by Kellogg India for the comparative evaluation of the international transaction involving the importation of finished products was not suitable.

3.2. The decision

Firstly, it's important to highlight that previous disputes between Kellogg India and the tax authorities for the fiscal years 2009-2010 and 2013-2014 were

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adjudicated by the Income Tax Appellate Tribunal, which reached similar conclusions. Notably, in its 2022 judgment, the tribunal largely referenced its earlier decisions. Central to this dispute was the application of the bright-line test.[24]

The bright-line test serves as a pivotal issue in this case, as it attempts to delineate the boundaries between routine business expenditures and those associated with intangibles and brand promotion, which may require different treatment for tax purposes. The bright-line test concept originated from the international ruling in the case of DHL Corporation & Subsidiaries vs. the Commissioner in the USA.[25]

This test is crucial for determining the appropriate allocation of expenses and income between Kellogg India and its foreign-associated entities, impacting the arm's length pricing of intercompany transactions. The consistent conclusions reached by the tribunal underscore the complexities involved in transfer pricing disputes, highlighting the importance of clear guidelines and consistent application of transfer pricing principles in multinational operations.

Therefore, below is an excerpt from the court's decision No. ITA No. 7342/Mum/2018:[26]

> In view of the aforesaid observations, we hold that Singapore AE should be considered as the tested party, being the least complex entity, in the facts and circumstances of the case, which has been rightly done by the assessee. Hence no adjustment to ALP is required to be made. Even if the comparables chosen by the ld TPO are considered, undisputably since the assessee is only engaged in the purchase and resale of goods without any substantial value addition thereon, RPM would be the MAM, and in case of RPM, only the gross margins are to be compared. We find that gross margins of assessee are much more than the gross margins of comparable companies chosen by the ld TPO. Hence no adjustment to ALP is to be made in respect of import of finished goods even if the comparable companies chosen by the ld TPO are upheld. Hence we hold that no adjustment to ALP is required to be made in the instant case in respect of import of finished goods in either case. Accordingly, the said adjustment of Rs 1,31,60,199/- is hereby directed to be deleted. Accordingly, the Additional Grounds raised by the assessee are allowed.

24 MIREMBE, Ruth. A Not-So-Bright Line: Advertising, Marketing, and Promotion Expenditure in India. Tax Notes International, volume 110, April 10, 2023. Available in: https://www.taxnotes.com/tax-notes-today-international/transfer-pricing/not-so-bright-line-advertising-marketing-and-promotion-expenditure-india/2023/04/27/7g7v3?highlight=kellogg#7g7v3-0000004. Accessed in: 27 July 2024.

25 JAIN, CA. Ajit Kumar. International Taxation Issue of Marketing Intangibles in India- Breath of Fresh Air. [s.l: s.n.]. Available in: https://kb.icai.org/pdfs/PDFFile5b4f2a2abc35f1.87547813.pdf. Accessed in: 31July 2024.

26 INDIA. India v. Kellogg India Private Limited (Case No ITA n. 7342/Mum/2018). Tax Appellate Tribunal. India: Mumbai, 2022. Available in: <https://tpcases.com/india-vs-kellogg-india-private-limited-february-2022-income-tax-appellate-tribunal-mumbai-case-noita-no-7342-mum-2018/>. Accessed in: 25 July 2024.

Shortly, the Tribunal ruled in favor of Kellogg India, overturning the initial tax assessment and affirming Pringles Singapore as the appropriate tested party for the transaction. This decision underscores the importance of accurately identifying the tested party in transfer pricing analyses and reinforces the validity of Kellogg India's approach to benchmarking its international transactions.

3.3. Important points of the decision, the tax audit, and kellogg's choice of method

Kellogg identified the RPM as the most appropriate approach for evaluating the controlled transaction involving the import and resale of Pringles chips in the Indian market. The selection of RPM was based on the factual nature of the transaction: Kellogg India acted as a limited-risk distributor that purchased fully finished products from its associated enterprise (AE) in Singapore and resold them in India without undertaking any processing, manufacturing, or significant customization. The AE itself had sourced the goods from a third-party manufacturer, adding only a 5% markup before supplying them to Kellogg India. Given that the product underwent no further transformation and Kellogg India's functions were confined to distribution, marketing, and sales, RPM was considered the most reliable method because it evaluates whether the gross profit margin earned by the tested party is consistent with that of independent distributors performing similar functions.

To apply the RPM, Kellogg India selected the AE as the tested party on the basis that it was the least complex entity in the transaction, it performed minimal functions, bore negligible market risk, and did not contribute any significant intangibles. A benchmarking analysis was conducted using a set of 14 comparable independent distributors operating in the Asia-Pacific region. The analysis produced an arm's length range of gross profit margins, with a weighted average of approximately 50.07%. Since the AE sold the goods to Kellogg India with only a 5% markup over its acquisition cost, the margins earned by Kellogg India comfortably exceeded the tested range, demonstrating that the transaction was conducted at arm's length.

Thus, the RPM was not only theoretically appropriate given the lack of value addition but also practically robust in its application. It allowed for a clear and transparent comparison based on gross margins, which aligned with the economic reality of the transaction. The Tribunal ultimately upheld the use of the RPM, finding that it correctly reflected the functional profile of the parties and provided a reliable measure of the transaction's compliance with the arm's length principle.

According to the tax authorities, the most suitable method would have been the TNMM. The authorities argued that the TNMM was more appropriate because Kellogg India was involved in complex business operations, including significant marketing, distribution, and risk-bearing functions within the Indian market. They claimed that the RPM was inadequate since it overlooked the sub-

stantive value-adding activities performed by Kellogg India. To support their stance, the tax authorities pointed to Kellogg India's substantial advertising, marketing, and promotion expenditures, which they argued benefited the foreign associated enterprise (AE) rather than Kellogg India itself, suggesting that the AE deserved a share of the profits.

Note that even though there is no hierarchy between the methods, it is recommended that when choosing the most appropriate method, the parts give preference to the traditional methods before the transactional profit methods. Kellogg was very assertive in doing so.

The tax authorities also contended that the financial data of the foreign AE and foreign comparables used by Kellogg India in its benchmarking study were unreliable or unavailable. Therefore, they selected Kellogg India as the tested party instead, arguing that its financial statements provided a more accurate reflection of the controlled transaction's economics within India. Using TNMM, they identified eight comparable independent companies from Indian databases and found an average net profit margin of 4.33%, which was higher than Kellogg India's reported net margin. Based on this analysis, the authorities proposed adjustments to increase Kellogg India's taxable income.

In summary, the tax authorities' allegations were grounded in the view that Kellogg India's business was sufficiently complex to warrant a net margin method and that the AMP expenses unduly benefited the AE. Their evidence relied on Kellogg India's functional profile, AMP costs, the lack of adequate foreign comparable data, and the comparative net profit margins of domestic Indian companies performing somewhat similar functions.

Also, in the tribunal's decision, a comprehensive analysis was undertaken concerning the operational roles and associated risks of Kellogg India in comparison to its foreign-associated entities. The tribunal examination was pivotal in distinguishing between the roles and risks borne by the entities involved in two specific transactions.

In the initial transaction, Kellogg India was responsible for the complete lifecycle of its products within the Indian market. This included manufacturing, marketing, and selling under a license. In contrast, during the subsequent transaction, Kellogg India undertook the importation and sale of products in India, incurring marketing and distribution costs. Notably, the tribunal recognized that Kellogg India assumed substantial entrepreneurial risk in these operations.

Conversely, the foreign-associated entities did not assume comparable risks in relation to the Indian market in either transaction. Given this analysis, the tribunal concluded that any marketing intangibles created within the Indian market are rightfully attributable to Kellogg India, which operates as a fully-fledged entrepreneur. This attribution of intangibles reflects the considerable risks and investments undertaken by Kellogg India, thus warranting no further compensation from the foreign-associated entities.

In doing so, the tribunal's reasoning aligns with the principle that merely holding licensor rights does not justify compensation if the licensor has not undertaken significant functions, employed assets, or assumed associated risks. Thus, the presence of licensor rights alone does not establish a basis for profit sharing if the licensor's involvement lacks substantive operational contribution and risk-bearing.[27]

In conclusion, the factual findings clearly establish that Kellogg India functioned as an entrepreneur, justifiably entitled to retain the entirety of the profits generated within the Indian market. The Tribunal carefully examined the operational structure and determined that Kellogg India's business was not excessively complex; it primarily engaged in routine distribution activities such as importation, marketing, sales, and customer support without undertaking manufacturing or substantial product modification. This limited functional profile meant that Kellogg India did not add significant value beyond standard distribution, which justified the use of the RPM, a method well-suited to such scenarios involving reselling finished goods without complex value addition.

Regarding the advertising, marketing, and promotion expenditures, despite the Tax Planning Officer's characterization of these expenses as excessive, the Tribunal found that they were consistent with industry norms and necessary to support sales in the competitive Indian market. These costs were properly incurred by Kellogg India and are appropriately deductible. The Tribunal further observed that these marketing activities reinforced Kellogg India's position as the entrepreneurial entity bearing the commercial risks.

The foreign-associated entity, on the other hand, did not merit any compensation. It did not undertake significant operational functions, deploy assets, or bear any substantial risk in the Indian market. Its role was limited to licensing and supply, without direct involvement in marketing or distribution within India. Therefore, the benefits derived from any marketing intangibles created are attributable solely to Kellogg India, reflecting its role as the principal entrepreneur in the transaction. This allocation aligns with international transfer pricing principles that reward the entity assuming real commercial risks and performing key functions, rather than a passive licensor.

4. Conclusions

In conclusion, as multinational enterprises continue to expand their operations across borders, the necessity for transparent and fair pricing mechanisms

[27] MIREMBE, Ruth. A Not-So-Bright Line: Advertising, Marketing, and Promotion Expenditure in India. Tax Notes International, volume 110, april 10, 2023. Available in: https://www.taxnotes.com/tax-notes-today-international/transfer-pricing/not-so-bright-line-advertising-marketing-and-promotion-expenditure-india/2023/04/27/7g7v3?highlight=kellogg#7g7v3-0000004. Accessed in: 27 july 2024.

becomes increasingly critical. Transfer pricing, with its intricate methods and adherence to the arm's length principle, serves as a key mechanism for ensuring that taxable profits are appropriately allocated to jurisdictions where economic activities genuinely occur. The examination of both traditional and transactional profit methods highlights the sophistication required to address the diverse nature of intercompany transactions and the importance of accurate and reliable data in applying these methods.

The traditional methods – Comparable Uncontrolled Price, Resale Price Method, and Cost-Plus Method – provide essential tools for evaluating transactions based on market comparables and cost structures. These methods, while foundational, require careful application to reflect the true economic value of transactions. On the other hand, the transactional profit methods – Profit Split Method and Transactional Net Margin Method – offer alternative approaches that focus on profit distribution, addressing situations where traditional methods may be less effective.

The analysis of Case No. ITA No. 7342/Mum/2018 illustrates the practical application of these methods and the tribunal's interpretative approach. By scrutinizing the tribunal's decision and the perspectives of both Kellogg India and the authorities, we gain insights into the real-world challenges and considerations inherent in transfer pricing disputes. The case demonstrates how the choice and application of transfer pricing methods can significantly influence the outcome of tax assessments and the fairness of profit allocation among related entities.

Ultimately, the tribunal's decision underscores the critical importance of applying appropriate transfer pricing methods to reflect the true economic contributions and risks undertaken by each party in international transactions. Kellogg's choice of the Resale Price Method was justified, given the nature of the transactions, as it effectively evaluated the gross margin from resales without significant value addition. This method proved to be more suitable than the Transactional Net Margin Method for specific circumstances, aligning with the principle of preferring traditional methods where applicable. The tribunal's thorough examination of Kellogg India's role and associated risks further validated this approach, demonstrating a careful alignment with the arm's length principle.

Even though the TNMM method could also be applied in this situation, the court was assertive by distinguishing between the operational functions and risks borne by Kellogg India and its foreign-associated entities, ensuring that the profits attributable to Kellogg India accurately reflect its substantial entrepreneurial investment and operational efforts.

The acknowledgment that Kellogg India rightfully retains the marketing intangibles and can fully deduct its advertising, marketing, and promotion expenses reaffirms the fair application of transfer pricing principles. Conversely, the foreign-associated entities' lack of substantial involvement and risk-bearing

justifies their exclusion from profit compensation. This outcome reinforces the importance of precise transfer pricing analysis in ensuring that profits are allocated fairly based on actual contributions and risks.

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