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Transfer Pricing with the added complexity of Intangibles

Authored By- Prakshat Thakkar

Over time multinational corporations (MNCs) have become an integral part of the economy. Naturally, most MNCs today are part of a group of companies wherein numerous transactions that include the transfer of goods and services take place internally between these associated enterprises. Since, these transactions are between companies that want to benefit each other, often the price that one company charges another is not on par with the market price. Charging below or above the market price allows MNCs to shift their profits/income from one country enterprise to another for the purposes of avoiding taxation and has become a common practice today.[1] This practice falls under the head of transfer pricing and has created an issue for tax authorities all over the world. Accordingly, regulation has been created to ensure that MNCs pay the same amount for the transfer of goods and services to their associated enterprises as they would otherwise pay to an unrelated enterprise. In the taxation world this amount is known as the arms length price. The legislation provides for different ways in which the arms length price can be calculated and every method prescribed may be suitable for one or more different types of transactions. However, when a transaction consists of a transfer of intangibles between two associated enterprises, there are added complexities for the determination of the arms length price. The very nature of intangibles complicates the process of transfer pricing and increases the difficulty for tax authorities who deal with the process. Hence, it is said that "intangibles are not only the subject of transfer pricing scrutiny, but one of the very reasons for the existence of the transfer pricing issue in the first place."[2] This paper will aim to cover the intersection between intangibles and transfer pricing, the challenge of determining ownership of the intangible, the problems with different methods of calculating the arms length price for intangibles and any possible recourse to solve these prominent issues of transfer pricing.

[1] Christian Bauer and Dominika Langenmayr, 'Sorting into Outsourcing: Are Profits Taxed at a Gorilla's Arm Length?' [2013] 90(2) JIE 326, 336.
[2] Jens Wittendorff, 'Valuation of Intangibles under Income Based Methods: Part I' [2010] 5 ITPJ 1385, 3074.

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As stated above, transfer pricing is the practice of determining a price for the trade of goods or services between two associated enterprises. These transactions are generally cross border transactions or international transactions, however, certain countries like India include specific domestic transactions as well.[3] The scope and meaning of international transaction in the Income Tax Act has widened over time via amendments made through the Finance Act and affirmations made in judgements. Further, the scope of an international transaction is inclusive of a transaction involving the transfer of intangibles between associated companies. Intangible assets for the purposes of transfer pricing have been defined under the Indian Act. They include intellectual property i.e. trademarks, copyrights, patents, trade secrets which are recognised under the OECD Guidelines too. In addition to this, the Act also recognises goodwill, contract and location related intangibles, human related intangibles, location savings and any other assets that are known for their intellectual value rather than physical.[4] Some of these above intangibles are not recognised globally due to not meeting the requirements of the OECD definition of intangibles i.e. only inclusive of intangibles that can be owned and controlled.[5] This means that India not only widens the scope of international transaction under transfer pricing but also the definition of intangibles for the same. This naturally increases the complexity of transactions dealing with both of the above concepts. Increased inclusivity is not necessarily a bad thing as it offers increased protection, however, in this case it can be said that India has shot itself in the foot by making things more difficult for themselves in an already complicated process.

The first challenge when dealing with intangibles for tax authorities is that of ownership. It is important for the tax authorities to separate the owner of the intangible property from the other involved parties in the transaction for the purpose of attributing the income from these intangibles to the rightful party and to impose the tax and transfer pricing consequences that arise thereafter.[6] The first type of ownership is legal ownership. This is a straightforward case in which the owner of the intangible will be the entity who has registered the intangible

[3] The Income Tax Act, 1961, sec. 92B.
[4] Kriti Chawla, 'Transfer Pricing of Intangibles: An Evaluative Study under the OECD and the Indian Environment' (September 2015).
[5] Organisation for Economic Cooperation and Development, 'Guidance on Transfer Pricing Aspects of Intangibles', 'Base Erosion and Profit Shifting Project' 2014, para 6.6 28-29.
[6] Martin Przysuski, Sri Lalapet and Hendrik Swanevald, 'Transfer Pricing of Intangible Property' [2004] 5 CBTM.

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according to the laws of the country.[7] However, this direct creation of legal ownership will only be possible in the case of some intangibles like intellectual property but might not be applicable to the other abovementioned assets included in the definition of intangibles. Hence, in cases where legal ownership is difficult to establish, guidance can be taken from Action Plan 8 of the BEPS compiled by the OECD which attributes legal ownership of the intangible to the entity that carries out the DEMPE (development, enhancement, maintenance, protection, and exploitation) functions for the intangibles.[8]

The second type of ownership is economic ownership which aims to attribute ownership to the entity that undertook the economic costs and risks for the growth of the intangible.[9] In most cases economic ownership is attributed to the subsidiary company who has been given access to the intangible by way of a licensing agreement drawn by the licensor i.e. the parent company and legal owner of the intangible. This is done to ensure that if certain costs and risks were borne by the licensee then they would be reimbursed for establishing a more accurate representation of distribution of returns between the two enterprises for the purposes of taxation of transfer pricing. The first test for establishing economic ownership and whether there should be any reimbursement was the *Bright Line* Test. It was laid down in the case of *DHL Corporation and Subsidiaries v. Commissioner*[10] that a certain amount of money is expected to be spent by the company for the exploitation of the intangible.[11] This in other words was denoted as routine expenditure. The court said when routine expenditure crosses the *bright line* it is an additional expenditure undertaken in the form of non-routine expenditure and this leads to the creation of a marketing intangible. It is this overspent expenditure that creates economic ownership and a right to reimbursement for the overspent/non-routine amount. Although, economic ownership is not recognised in India through the Act or Rules[12], this test was adopted in India in the case of *Maruti Suzuki India Ltd. v. A.C.I.T.*[13] wherein the foreign company i.e. Suzuki was asked to compensate the amount spent by the Indian company i.e. Maruti. Suzuki was asked to do so because through the sale of an intangible it inherited and

[7] *Kriti* (n4).
[8] *OECD BEPS* (n5), para 6.68 52.
[9] Martin Przysuski, Sri Lalapet and Hendrik Swanevald, 'Determination of Intangible Property Ownership in Transfer Pricing Analysis' [2004] TNI 285,296.
[10] US Court of Appeals [2002].
[11] ibid.
[12] *L.G. Electronics India Pvt. Ltd. v. Assistant Commissioner of Income Tax* [2013] 140 ITD 41.
[13] [2010] 328 ITR 210.

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benefited from an already established brand in India and any expenditure spent by Maruti for this brand building was to be compensated as it had created a marketing intangible. However, this case was one of few cases where the *bright line* test abundantly used in the U.S.A. was adopted in India. Today, the paradigm in India has shifted by way of several case laws. The landmark case of *Sony Ericsson Mobile Communications India Pvt. Ltd. v. C.I.T.*[14] denied the usage of the *bright line* test and stated that the mere spending of AMP (advertising, marketing, and promotion) expenditure cannot be the basis of compensation.[15] It stated that brand building is just one of the factors that backs and justifies the spending of AMP expenditure[16] and that there are additional factors one should take into consideration for the transaction to constitute economic ownership. These factors included but were not limited to examining whether the intangible continues to be exploited over a long period of time and whether the intangible is used by the foreign company for additional benefits.[17] Evidently, this shift from the simple *bright line* test has created a more elaborate procedure for tax authorities to determine whether a company must be compensated for the purposes of transfer pricing. When looked at from the point of view of the tax authorities this leads to the development of a more complicated procedure, however, from the point of view of a developing nation a more detailed and strict procedure will only lead to more cases in which the economic owner does not have to be compensated in turn increasing the taxable amount and revenue of the country.[18] Therefore, this shift can be seen as a positive move in the long run.

The second and major challenge that tax authorities face arises in the valuation of the arms length price of an intangible. There are several well-known methods provided for the calculation of the arms length price, however, it can be said that a lot of these methods are not fitting for intangibles because of the distinctive characteristics of intangibles and variations of license agreements.[19] Section 92C of the Income Tax Act, 1961 provides for these different methods, 1) Comparable Uncontrolled Price (CUP) method, 2) Resale Price method, 3) Cost Plus method, 4) Profit Split Method, 5) Transaction Net Margin Method (TNMM) and 6) other

[14] ITA No. 16 of 2014.
[15] ibid.
[16] ibid.
[17] ibid.
[18] *Kriti* (n4).
[19] Arjun Chhabra, 'TP Niche: A spectrum of transfer pricing issues' (*Grant Thornton,* 19 October 2016) https://www.grantthornton.in/insights/articles/tp-niche--july-september-2016-edition/ accessed 18th October 2021.

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method prescribed by the board.[20] The first three methods can be categorised as the traditional methods whereas the remaining definite methods are known as the profit methods. The traditional methods are direct[21] and simple in nature when compared to the profit methods, therefore, they are preferred by the OECD in a scenario where either of the methods could be used for calculating the arms length price. However, despite being higher in the preferential order, each of the three traditional methods encounter a common set of problems when dealing with intangibles.

The first method of CUP uses the price of a similar past transaction involving the transfer of the same product made under similar circumstances between two unrelated enterprises (uncontrolled transaction) as the arms length price for the current transaction between associated enterprises (controlled transaction). While using this method, it is not enough to ensure that the transfer is of the same intangible but that the transactions being compared also have similar circumstances i.e. characteristics of the intangible property, licencing terms etc.[22] Generally, the tax official attempts to use the internal CUP method first wherein he/she looks for a transaction previously undertaken by the group of companies with an unrelated party which is similar in nature to the current transaction at hand.[23] In most cases this internal CUP method attempt fails as it is a rare occurrence that a company has entered into a similar transaction under the same circumstances before, therefore, the official has to revert to the external CUP method. This is when global databases/open markets are searched to find a similar transaction. In the case of intangibles even this is a tough ask since the availability would depend on the particular industry of the intangible and its prevailing history of licensing and the disclosure requirements for its transactions.[24] The importance of the availability of data was acknowledged in the case of *UCB India Pvt. Ltd. v. A.C.I.T.*[25] where the tribunal stated that the CUP method performs a high degree of comparability and in the absence of sufficient data it would not be suitable to apply this method.[26] Even though Indian courts and tribunals have stated that the CUP method is available for calculation of the arms

[20] The Income Tax Act, 1961, sec. 92C(1).
[21] Organisation for Economic Cooperation and Development, 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' 2010, para 6.1 191.
[22] *Kriti* (n4).
[23] *Arjun* (n19).
[24] ibid.
[25] [2009] 121 ITD 131 (Mum).
[26] ibid.

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length price for intangibles[27], it is a common occurrence that the tax officials cannot use this method due to the cause of insufficiency of data.[28] Therefore, the usage of this method for intangibles depends on the facts, circumstances and availability of data in each case.

The resale price method faces an issue similar in nature as it calculates the arms length price by comparing the gross margin earned by the subsidiary from the resale of the intangible purchased from its parent company to the gross margin earned by other uncontrolled entities by performing an act similar in nature.[29] The issue persists as "gross profit information for comparable uncontrolled distributors may neither be available nor reliable as a benchmark for an arm's-length standard"[30], thus, making the usage of this process illogical. Similarly, the last traditional method i.e. cost plus method also faces the problem of the unavailability of information for creating a comparison. The price in this method is found by multiplying the cost of producing the intangible into an approximate gross profit percentage for the functions the intangible carries out.[31] The basis for the gross profit percentage is the comparison of uncontrolled sales which brings us back to square one. Further, this method also tends to undervalue the transfer price as it assigns all the unallocated profits accruing from the transaction to the buyer.[32] This helps us conclude that only the CUP method out of the traditional methods is suitable for evaluating the arms length price and its applicability is further restricted to extremely rare circumstances.

The profit methods can be looked at for a solution, however, they come with their own set of problems too. The first method is the profit split method. Rule 10B(1)(d) of the Income Tax Rules, 1962 provides for the instances in which this method can be used wherein one of the instances is the transfer of unique intangibles in international transactions.[33] Therefore, this makes this method of valuation for the arms length price appropriate to the issue at hand.

[27] *SKOL Breweries Ltd.* ITA No. 6175 of 2011, *Sygenta India Ltd.* ITA No. 2977 of 2006, *EKL Appliances Ltd.* [2012] 345 ITR 241/209.
[28] Marcus Collardin and Alexander Vogele, 'Knowledge Intangibles – Leveraging the Tax Advantages' 7 ITR 59,61.
[29] Wagdy Abdallah and Athar Murtuza, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals' [2006] 32 ITJ 5.
[30] John Warner, 'Taxing Interbranch Dealings: Application of separate taxpayer arm's length principles to inbound interbranch distribution dealings' [2002] 31(3) TMIJ 155,170.
[31] *Wagdy* (n29).
[32] ibid.
[33] The Income Tax Rules, 1962, rule 10B(1)(d).

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Further, if applied properly this may be a good alternative to the traditional methods which cannot be applied in numerous cases involving intangibles.[34] However, there exist practical problems in the application of this method.[35] This is because the calculation of the arms length price is dependent upon profits given from the company itself and these numbers may not be reliable.[36] Tax officials are aware of this from their past experiences, hence, they prefer not to use this method as they "almost always detect aspects they can criticize."[37] As a result, many countries are not willing to adopt this process and the same is also considered as a last resort by the OECD guidelines. However, in the Indian context the roots for this method are established[38] and it can be applied to transactions provided that is used with precaution.

The second profit method i.e. TNMM compares the net profit of the taxpayer part of a controlled transaction to an external or internal comparable.[39] Since, this method again involves a test of comparison, it is evident that the issue of availability of comparable data arises again. However, this issue exists on a much smaller scale as TNMM has certain differences in comparison to the traditional methods. Firstly, it provides a markup on total costs rather than a markup on total sales.[40] Secondly, the scale on which the TNMM creates a comparison is not as stringent as the traditional methods which makes the process more lenient towards any transactional differences.[41] Thirdly, the scope of data required is not that great for the method off TNMM as in traditional transactions.[42] This makes the process simpler and more efficient in terms of cost. On the negative side this leniency in application also makes the method less direct and accurate. Further, the Indian courts have added to the complexity of this method as they have continuously bickered on who should be the tested party i.e. the party whose profit would be tested. In some cases it was held that the tested party should always be the Indian enterprise[43] while in others it was held that the tested party should be the entity for whom

[34] Victor Miesel, Harlow Higinbotham and Chun Yi, 'International Transfer Pricing: Practical solutions for intercompany pricing – Part II' [2003] 29(1) ITJ 1,40.
[35] *OECD* (n21), para 6.26 200.
[36] *Kriti* (n14).
[37] Alexander Vogele and Markus Brem, 'Do APAs prevent disputes?' [2003] 14(1) ITR 35.
[38] *Aztec Software & Technology Services Ltd v Assistant CIT,* [2007] 107 ITD 141/15.
[39] *Kriti* (n4).
[40] *Wagdy* (n29).
[41] ibid.
[42] ibid.
[43] *Onward Technologies Limited v DCIT,* [2010] ITA No. 7985 (ITAT Mum).

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comparable parameters can be easily found.[44] How can tax officials be expected to use this method when discrepancies about basic foundations of the method are not solidified?

Considering the abovementioned apparent flaws with each of the valuation methods and the inapplicability of the same in several cases due to the involvement of intangibles, one would think that a more competent method would be established under the provision of 'other methods' by the authorities. While there exist many alternative methods, only the excess earnings method seems to have had played a role in the Indian context.[45] Herein, the price of the intangible is the present value of the profits attributed to the intangible after deducting all other profits resulting from other contributing assets.[46] While acknowledging that this method is a complex valuation technique, the fact that courts have considered an alternative valuation technique seems to be a positive step to help solve the issue of valuation of the arms length price.

Nevertheless, this issue is still prominent worldwide and is here to stay. This is because no matter what valuation technique one uses, the law allows the tax authorities a certain amount of flexibility to make judgement calls to reach a desirable arms length price. This leads to the deviation of the tax authorities from the accurate transfer price and results in them settling for an inaccurate price. Unfortunately, this creates an advantage for MNCs who may continue to exploit such inaccuracy especially if the company abundantly deals with intangibles.[47] The problem has worsened over time due to the law prescribing only a limited number of valuation methods leading to desperation and experimentation of untested/unapproved valuation methods by the tax authority. Further, most of these established methods are comparison based and when one compares the current transaction to previous transactions, the authorities are not necessarily establishing accurate results as they may just end up adopting an inaccurate result all over again. These problems are inherent with the principle of the arms length price and cannot be done away with. An advocate for the current principle will argue that complete accuracy is a fiction but the same can be changed with the adaptation of a formula based process

[44] *Development Consultant Pvt. Ltd vs. DCIT,* [2008] 115 TTJ 577 (Kol).
[45] *Tally Solutions Pvt. Ltd. v. DCIT* [2011] 576 TS ITAT (Bang).
[46] Ashutosh Mohan Rastogi, 'Analysing the Sixth Transfer Pricing Method – Implications Et Al' (*Taxsutra,* June 2012) http://www.tp.taxsutra.com/experts/column?sid=58#content-bottom accessed 18 August 2021.
[47] Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes' [2008] 28 VTR 79.

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for the valuation of intangibles in transfer pricing. Admittedly, this seems easier said than done but in one way or another, the situation regarding transfer pricing and intangibles must change. Whether this change be brought by doing away with the arms length principle completely and adapting a formula based approach or by introducing a new valuation method that has been created especially for calculating the arms length price of intangibles is in the hands of the tax authorities and legislators to decide.