TRANSFER PRICING - UNVEILING AN ESTABLISHED CONTROVERSY

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ABSTRACT

This paper examines transfer pricing in relation to royalties in the telecommunications sector, highlighting industry-wide challenges. Using a case study of Philips, a major high-tech firm, it illustrates the procedures surrounding royalty transfers to parent companies and their role in fostering Intellectual Property (IP) and innovation. The paper also contrasts the ethical and tax perspectives on transfer pricing, emphasizing their influence on industry growth and deterrence of tax evasion. Finally, it proposes effective methods to resolve transfer pricing issues between multinational enterprises and governments.

INTRODUCTION

With globalization, many multinational companies (MNCs) choose to centralise their Intellectual Property (IP) by confining ownership to very few, or even to a single legal entity, within the group. From a commercial standpoint, the centralised approach is typically driven by the ease of enforcing legal protection, efficiency, and consistency in IP development and management. The IP-owning entity then licenses the use of IP to relevant users around the world. This leads to issues relating to recognition and valuation of IP licensing transactions referred to as transfer pricing.

Transfer pricing being an economic term can be defined as the amount that is charged by a part or segment of an organisation for a product or service that it supplies to another part or segment of the same organisation.

The concept of transfer pricing mainly talks about the prices that are established for intra-group, cross-border transfer of goods, intangibles and services. It refers to setting the prices at which transactions occur involving the transfer of property or services between affiliated enterprises, forming part of a Multinational enterprise group (MNE).

The fact is that a significant volume of global trade consists of international transfer of goods and services, capital and intangibles such as intellectual property within an MNE group. Such transfers are called “intra-group” transactions. There is evidence that intra-group trade is growing invariably, and arguably accounts for almost 30 percent of all international transactions. The structure of transactions between MNE groups is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities.

Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group. It therefore becomes important to fix the right price called the ‘transfer price’ for intra-group, cross-border transfer of goods, services and intangibles.

These transactions are also referred to as “controlled” transactions, which are different from “uncontrolled” transactions between companies that are not affiliated and can be assumed to operate independently or on an arm’s length basis, in reaching terms for such settlements. The arm’s length standard is wherein none of the parties are related to each other or have common interests, hence, they are considered to be at an arm’s length distance.

Arriving at an apropos transfer price is a complex task because of the difficulty in classifying intangibles and services which were transferred or provided and the price at which they are to be valued.

For example, intangibles could be of various different types such as: industrial assets like patents, trade types, trade names, designs or facsimiles, literary and artistic property rights, technology or trade secrets. Sometimes such intangibles are reflected in the accounts and sometimes not. Thus, there are many intricacies involved which have to be taken into account while dealing with transfer pricing in cross-border transactions between MNE entities.

ISSUES UNDERLYING TRANSFER PRICING

The main issues underlying transfer pricing are that it determines the incomes of both parties involved in the cross border transaction. The transfer price consequently forms the tax base of the countries involved in cross-border transaction. Secondly, in any cross-border tax scenario, the three bodies involved are the multinational group, taken as a whole, along with the tax establishments of the two countries involved in the transaction. When one country's tax authority levies taxes on a unit of the MNE group, it has a consequence on the tax base of the other country. In other words, cross-border tax issues contains aspects related to jurisdiction, allocation and valuation.

In case of jurisdictional issues, the aim is to usually decrease a multinational group's worldwide taxation by shifting profits from allied entities in higher tax states to allied entities in relatively lower tax countries through either under-charging or over-charging the MNE for intra-group trade. The net outcome is to maximise an international enterprise's after tax profits.

For example, if an international enterprise has a tax rate of 30% in the residence country of the parent company of 30% and it has a subsidiary entity resident in another country with a tax rate of 20%, the parent has an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. If the parent company shifts $100 million of taxable profits to its subsidiary, it will make a tax saving of $10 million. This can be achieved by the parent company being over charged for the acquisition of property from its subsidiary.

However, the question that arises is that which country will be imposing taxes on the company as in some cases an international enterprise may wish to take advantage of an associated company's tax losses before they expire, in conditions where losses can only be carried forward for a definite number of years. Even if there are no boundaries on carrying forward tax damages by an affiliated company, the international enterprise has a motivation to use the losses as quickly as possible. In other words, profits may occasionally be shifted to certain nations in order to acquire specific tax benefits.

The allocation of resources is another issue to be dealt with. As in order to evade tax or maximize tax benefits the MNEs shift resources in the form of economic transactions with one another distorting the allocation of resources. Furthermore, many of the common resources which are a source of competitive advantage for the MNEs cannot be disentangled from the global income of the MNEs for tax purposes – this is especially true in the case of intangibles and service-related intra-group transactions.

IMPORTANCE OF TRANSFER PRICING

However after all this being said, we must also quote the importance of transfer pricing as despite its tax issues, it is of critical importance to the MNEs, for example, two companies merge operations and the larger of the companies might have technology, trademarks or other intangibles that the newly acquired company would like to use, now, the means of procuring this technological knowledge is through the transfer of technology and know-how licensing as both play an important role in the development process and they have been given a high level of importance by different governments with a view to develop the economic standards of countries lacking in technology or with an aim to disseminate knowledge.

In this case, an arm's length royalty rate would have to be established for use of the intellectual property, and a stable price would have to be negotiated for outright transfer of the asset from the parent to the subsidiary. Therefore, transfer pricing is the method encouraged by tax authorities of setting appropriate and market based values and royalty rates for use and attainment of intangible assets. Most governments of developed countries have stated fairly analogous regulations for appropriate transfer pricing, constantly referring to market-based methods to establish the royalty rate or transfer price.

Technology transfer is what forms the basis or is the cause for transfer pricing, and this transfer of technology holds great importance as it is responsible for the growth of the MNEs. An example of one of the largest high-tech companies in the world- Phillips can be stated to prove the above statement. Phillips is an MNE active in healthcare, lifestyle and technology, it has five product divisions' namely medical systems, consumer electronics, domestic appliances, lighting and semiconductors and each of these divisions is renowned for its state of the art technology. Phillips invests billions of dollars each year in R&D and as a result produces about seven thousand documented new ideas and inventions every year which amounts to approximately 30 inventions per day, consequently generating more than 3000 patents per year along with 800 scientific articles. Phillips at present holds more than 10,000 patents.

The reason behind the company's massive success is its spirit of open innovation and its cooperation with outsiders and it was one of the first major high-tech companies to engage proactively in patent in patent licensing. Phillips offers a broad spectrum of technological know-how, software and product related technologies to its subsidiaries enabling it to become one of the most efficient companies in its field.

One example of successful technology licensing by Phillips is the CoolFlux DSP core. This Digital signal processing technology provides a standard chip platform allowing for increased audio quality in application of ultra-low power consumption in the audio industry. This technology is particularly well suited for applications such as hearing instruments, MP3 players and earpieces. The CoolFlux DSP technology is based on years of investigation and product experience in the field of digital audio and ultralow power know-hows at the Phillips Digital Systems Lab in Leuven (Belgium). PDSL is one of the founding associates
Of DSP valley which is a technology networking association with more than 1800 DSP engineers, also headquartered in Leuven. CoolFlux DSP core is easily programmable with development tools provided by DSP valley Partner Target Compiler Technologies.
Phillips has the intention to use the technology in its own product, but not exclusively, it has already licensed the CoolFlux DSP programme to four other associates. In May 2004, Phillips closed the first technology licensing contract for the transfer of the CoolFlux DSP core.

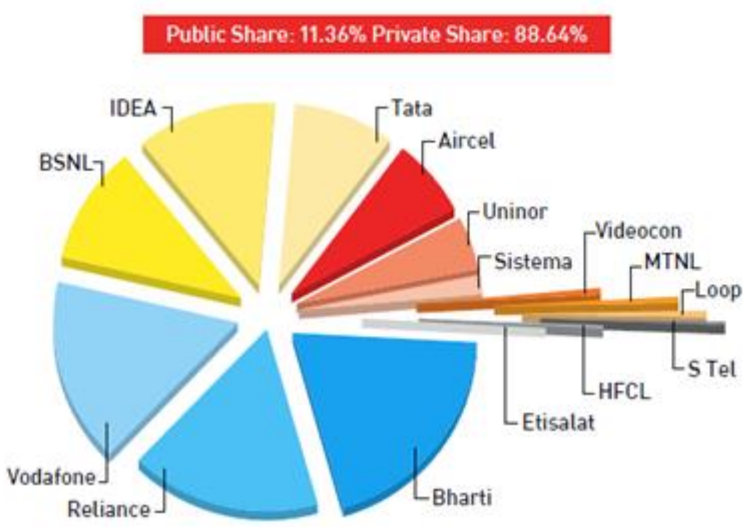
The technology was licensed to Dspfactory, a Canadian based semiconductor company that is a leading supplier of miniaturized DSP technology. Dspfactory wanted CoolFlux DSP core to implement in its future generations of products for digital hearing instruments and other audio devices, offering clients a platform that is ultralow power, rich in feature, and exceptionally flexible. Since then Phillips has licensed the CoolFlux DSP core to another three companies: two in China and one in South Korea.

This example illustrates how technology licensing is used to commercialize IP and is used as an effective method to attain royalty for the parent company and thus it need not always come under the ambit of transfer pricing issues.

In the case of LG Electronics India Pvt. Ltd. The special bench of ITAT in its detailed order said that incurring advertising, marketing and promotion (AMP) expenses by the tax payer towards building a brand legally owned by the foreign affiliate constituted a transaction and the foreign entity should pay the AMP expenses above the bright line .

TRANSFER PRICING IN TELECOMMUNICATION SECTOR

The telecommunications sector in India has been the fastest growing industries since the past decade and is likely to proceed in a similar growth path in the coming years. A report prepared by the telecom regulatory authority of India (TRAI) suggests that the total user base in India since January 2013 is 863 million out of which 708 million were active mobile users. Today, the Indian telecom sector is the largest in the world after China. A liberal policy regime and involvement of the private sector have played a major role in the positive transformation of the sector. The liberalization of the sector has not only led to rapid growth but it has also helped a great deal towards the maximization of consumer benefits evident from the huge fall in tariffs and the widening user base. The major players responsible for growth in the sector are as many as fifteen in number.



However, tax payers in this sector inherently have high intellectual property content and the time gap between investments and return can be long, leading to fluctuating returns for these industries. Moreover in India, this industry is undergoing continual growth leading to even more unpredictable returns. For instance, one major player in the telecom industry- Reliance communication limited was barely able to break even last year where it’s counterpart, Bharti Hexacom – earned an operating margin of about 30%. As a result this industry has been increasingly under the lens of the Indian Tax authorities from a transfer pricing perspective.

The telecom sector has been facing audits under various spectres, most of which relate to basic transfer pricing analysis such as the type of comparable companies selected.

For instance Vodafone Group, the world's largest telecom company by revenue was taxed by the Indian Tax authorities over capital gains on an overseas transaction between 2 foreign companies having non- residential status in India of sale of investments comprising of shares of an Indian Company. Vodafone telecommunications then challenged the Income-Tax Department's notice regarding the transfer pricing case due to the department charging the company with a massive Rs. 11,200-crore demand notice to the British telecom major on the capital gains arising from its $11.2-billion offshore deal with Hutchison Whampoa in 2007. Over this deal, Vodafone International had acquired a controlling interest in the Indian telecom unit of the Hong Kong-based Hutchison Whampoa, then Hutchison Essar. In January 2013, the Income tax Department had sent a "aide-mémoire" seeking Rs. 14,000 crore in dues, comprising of interest on delayed payment to which Vodafone reciprocated by initiating talks with the union government to come up with a solution regarding the same. The Supreme Court finally held that Vodafone is not legally obliged to respond to Section 163 notice which relates to the treatment of a purchaser of an asset as a representative assesse.

Another case was against the Invensys India Pvt. ltd. wherein the Delhi Bench of the Income Tax Appellate Tribunal said that the scope of transfer pricing adjustment should be limited to international transactions only and such value cannot exceed the value of the international transactions. On this basis the lower appellate authority dropped the demand as the demand notice had been issued beyond the normal period of limitation.

These problems mainly arise because, what is a just transfer price to one country's tax authorities may not appear to be fair to another country. For example, the IRS would want to see subsidiaries of US companies paying extremely high royalty rates to the US firms for the use of intellectual property as this would observably stimulate income to the American parent company, and, as a result, would lead to tax revenue. At the same time, foreign governments would like to see the royalty rate paid to the American parent company minimized again since that would decrease the amount of outflows paid by the overseas subsidiary in royalty rates, thus absorbing more revenue in its own state and thus generating more tax revenue for that country.

TRANSFER PRICING AND ROYALTY

Payments of brand names, trademarks and technical expertise by the Indian affiliate to the overseas MNE are hence often challenged by the Indian tax authorities. The concept of benefit testing is also brought to play here, it is a hands-on tool to gauge the impact of a royalty commitment in a technology contract to the business interests of the contracting parties.

In the case of Samsung India Electronics Pvt. Ltd., the tax officer challenged the payment of Royalties to Samsung Korea for technical proficiency on sales made to the MNE group, arguing that those sales tantamount to sales to itself. The Delhi income Tax appellate tribunal, held that the sales made to another MNE group do not amount to sales to itself.

Another case regarding royalty was filed against Cadbury India, a subsidiary of M/s Cadbury Schweppes PLC, U.K. Cadbury group has presence in more than 200 countries and it enjoys the distinction of being world’s third largest soft drinks company in sales volume and is among the fourth largest confectionary company in the world. With regard to Royalty on technical knowhow, it was found that the Cadbury India had entered into an agreement with its parent AE on 09.03.1993, with the approval(s) of SIA, Government of India, which were granted at various points of time. According to that agreement Cadbury India agreed to pay royalty at 1.25% of international sales and exports against which the parent AE shall supply and disclose and make available to CIL (Indian Co.) all knowhow, advice and assistance at all such time that may be mutually agreed between the parties. On the basis of the information gathered from other Cadbury units across the globe, the Transfer Pricing Officer enquired as to why the gross 1% of gross sales be not taken to be at arm’s length instead of 1.25% taken by the CIL in the case of technical know- how. However, the case went in favour of Cadbury India Limited as it was found that the transactions were made at

an arm’s length.

These cases prove that the exchanges of profits made by MNCs, which are indeed necessary for their growth is often suspected by the income tax authorities who view this process as a convenient method of tax evasion, whereas for most companies, they are merely following the agreement signed by them wherein they will get the technical know- how from the parent company in exchange of the share of profit that they give. Hence, these exchanges are imperative for the growth of these industries and therefore despite the common notion of tax evasion subjected to the nature of such exchanges, it must not always be looked upon with an eye of suspicion.

Another facet of this discussion is about the way MNEs should form their transfer pricing policies. They should be framed in a manner that they balance out both the external and the internal motivations. This is the benefit that MNEs get over unrelated companies as MNEs can choose a price that jointly maximises their profits, this is also called as the profit maximising transfer price.

Most of the MNEs set transfer pricing policies keeping in mind three objectives, namely: maximizing consolidated after tax profits, determining the performance of domestic and foreign divisions and lastly tax minimization. In most MNEs, this decision is taken by the top executives of the parent company. Therefore, transfer pricing for MNEs is not merely a tax concern but is also treated as a strategic decision. MNCs can accomplish significant financial and economic benefits by integrating tax and operations at every step of the value chain, another advantage includes the ability to enhance shareholder value by pre-emptively driving out unnecessary tax costs within the boundaries of the arm’s length principle via a close alignment of tax and business structures.

However, these transfer pricing tactics often get linked to tax fraud, many argue that the ethics of transfer pricing differ depending on whether one taxes a moral ethics perspective or a tax ethics view.

Moral ethics perspective argues that an MNE has responsibilities beyond its shareholders that contains all the firm’s stake holders. Stakeholders are any group that can affect or is affected by the achievement of the MNE’s goals or any persons or groups with legitimate interests in procedural and functional aspects of the firm’s activities. Stakeholder theory assumes that values are an essential part of directing business, and managers divulge their values, preferences and biases by engaging in corporate social activities. Therefore the moral accountability of business includes being socially responsible. There are some records that argue that firms also benefit from investing in socially accountable activities as a positive corporate standing is concomitant with a significant market value premium, greater financial performance and lesser cost of capital.

The tax ethics view on the other hand states that the social responsibility of business is to use its resources and engage in activities designed to increase profits as long as the firm is operating within the legal limits of law, without fraud or deception. Therefore, in a tax ethics perspective, any activity which is not directly illegal is considered ethically moral.

This dilemma about the issue is essentially caused due to the lack of a proper mechanism through which valuation of IP can take place as a result of which there is a risk of taxes being levied on MNCs which are well under the arm's length and are not involved in any malice like tax evasion. As we know, IP markets are still in the evolutionary stage, therefore it becomes difficult to arrive at the correct market price of such intangibles through demand and supply.

POSSIBLE SOLUTIONS

There are some ways through which the tax authorities of countries and the MNEs can come to a settlement. This can be done by reducing and bringing about a mutual understanding between the two bodies and addressing the concerns and the motivating factors behind this malice that is done by arguably a limited number of companies, nonetheless, it's brunt is borne by most MNCs due to the stringent laws imposed on transactions of this nature and the eye of suspicion with which they are looked upon in cases involving transfer of royalty.

For instance in Europe, the European Union has come up with a long term comprehensive strategy in corporate taxation in Europe. This policy proposes two main changes with respect to the mechanism followed by the individual member states would tax EU multinational enterprises. Firstly, instead of computing their tax base as per the rules of each individual member state, they would have the option to use a single set of tax rules that would hold true for all its subsidiaries in different European countries. Secondly, these enterprises would distribute this tax base across the individual member states where they did business using agreed common apportionment formula. Keeping in mind the sovereignty of each member state in the cases of levying direct taxes, the individual states would apply their own tax rates to their apportioned share of the single consolidated EU tax base. However, there are certain assumptions underlying the apportionment formula, firstly the countries need to have the same currencies in order to avoid currency exchange rates, it should also have a common accounting standard as they would provide common definition of concepts that are important for the functioning of the formula.

CONCLUSION

In this article, we begun by introducing the concept of transfer pricing in great detail, and further explained the issues underlying transfer pricing with respect to jurisdiction, allocation and valuation of IP. A case study of one of the largest high-tech companies in the world, Phillips, is shared to bring forth the procedure that follows before and after the transfer of Royalty to the parent company and how this transfer helps in the growth of the industry in terms of IP and innovation. Further, light is put on the telecom sector which is further discussed in relation to the issue of transfer pricing. Various cases have been quoted wherein defendants (industries) from the telecom sector are declared innocent as their transactions were well under the arm's length. We then talk about Royalty, specifically from intangibles, in relation to taxes that are levied on them by the income tax authorities of the concerned country. We further explain the moral ethics perspective and the tax ethics perspective, both of which play a major role in the growth of industries and deters them from tax evasion tactics. Lastly, effective solutions are given to settle this issue of transfer pricing and a practical remedy is also quoted as being followed currently by the European Union.