

Transfer Pricing Issues in Intangibles (Intellectual Property): An analysis of problems and possible solutions

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## 1. INTRODUCTION

Transfer pricing means the price charged between related parties for goods, services, or use of property.<sup>29</sup> In a globalised world, a single corporate taxpayer undertakes business across the world and therefore its recourses are deployed across multiple taxing jurisdictions. Some of jurisdictions levy tax at high rate and some are low tax jurisdictions. The mismatch of rate of tax on income in different national taxing jurisdictions is reason and guiding force for any multi-national enterprises (MNEs)<sup>30</sup> to plan the allocation of resources and assets in the most tax efficient matter. The said tax efficient method is looked with suspicion by tax authorities, and it is allegedly called as shifting of profits to relatively low-tax jurisdictions through intra-firm transfer pricing, creating what is called the transfer pricing problem.

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<sup>29</sup> “Transfer Pricing” BusinessDictionary.com, November 18, 2010 <http://www.businessdictionary.com/>

[definition/transfer-price.html](http://www.businessdictionary.com/definition/transfer-price.html)

<sup>30</sup> A multinational enterprise (MNE) is a company that is part of a “MNE Group.” An MNE Group consists of related corporations or similar entities operating in more than one country. Organisation for Economic Co-operation & Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at G-6 (2001) [hereinafter OECD Guidelines].

Among the transfer pricing transactions of MNE Groups, intellectual property (herein after referred to as 'IP') related transfer prices are the most significant and susceptible to dispute with tax authorities. The main reason for IP related transfer pricing disputes is the high value of IP's high value the complexity of IP-related issues.<sup>31</sup>

IP carries tremendous value because it often produces or has the potential to produce enormous amounts of royalties. Further IP is an intangible<sup>32</sup> paper asset without any physical presence; it is easily transferable from one country to another. Thus, IP-related financial problems exist in commercial practices, valuation, and accounting as well as in attribution of income for tax purposes. Consequently, transfer pricing of IP is a major area of dispute and litigation.<sup>33</sup>

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<sup>31</sup> Wu, Ronald, "Transfer Pricing: Current Problems and Solutions" (2010). *CMC Senior Theses*. Paper 87.

[http://scholarship.claremont.edu/cmc\\_theses/87](http://scholarship.claremont.edu/cmc_theses/87)

<sup>32</sup> "Intangibles" are property lacking physical substance and existing merely on paper. BLACK'S LAW DICTIONARY 811 (7th ed. 1999). Tax law considers patents as common types of intangibles. Intangibles are often defined slightly differently for different purposes, even in the tax law. I have chosen to refer to "IP" rather than intangibles in this article.

<sup>33</sup> For example, Enron (US based company) used off-shore MNEs to create "opaque corporate structures" which wiped out its corporate income taxes in India, Hungary, and (for one year) the United States. See Steven Filling & Prem Sikka, Taxing the Boundaries of Corporate Social Reporting, 33 PUB. INT. 21, 22 (2004), available at <http://aaahq.org/PublicInterest/newsletr/Fall04/fall04.pdf>.

This short article will briefly discuss the some of the transfer pricing issues in the context of the IP and widely proposed legal reforms providing for solutions for the same. It may be noted that this article neither argues for justifications of particular transactions nor questions the legal validity of the same. The only purpose of this article is to highlight the areas of disputes between the taxpayers and the tax department, and to offer possible legal solutions for avoiding those disputes.

## **2. TRANSFER PRICING MANAGEMENT AS A TOOL FOR TAX EFFICIENCY**

Transfer pricing is a significant for both the taxpayers and tax administrators because it is used for cost allocations having a large impact on income, which ultimately determines a corporation's taxable income.

One of the major issues the tax officers in India are dealing with, involves legally shifting profits out of the India to tax havens like Bermuda, Switzerland, Ireland, Singapore, and the Cayman Islands. These nations have lower corporate tax rates in comparison with India. Some even have special tax exemptions for operating businesses in their country which pose large financial benefits. By taking advantage of these foreign tax rates and exemptions, multinational corporations are lowering their international tax rates and reporting higher profits.<sup>34</sup>

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<sup>34</sup> See also Russ O'Haver et al., *Improving Deals with Transfer Pricing*, 5 INTER CHANGE 4 (Dec. 2004). MNE Groups can minimize their taxes through three types of activities: tactical (profit shifting

### **3. MECHANISMS OF TRANSACTIONS PERTAINING TO IP**

The efficient tax management or according to tax authorities, allegedly tax evasion may be undertaken by the MNEs in various ways such as Intangible property can be shifted to foreign principals with a transfer of ownership, cost sharing or licensing agreement.

#### **3.1 Transfer of ownership**

The transfer of ownership entails the sale of IP developed by one entity to a related affiliate in a different tax jurisdiction. In such a transaction, the tax authorities raise dispute in respect of the sale price on the various grounds such as nature of developed IP, the profit potential from exploitation of the subject IP and the resultant value of the IP.

#### **3.2 Licensing**

The licensing of any IP by one company to an associated enterprise typically involves a commercial arrangement whereby the licensee pays a royalty, usually specified as a percentage of the licensee's sales, to the licensor for the rights to exploit the associated intangible in the designated territory. A licensing agreement between an Indian parent

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activities), operational (financial restructuring), and tax planning (MNE Group structure reorganization).

and its foreign principal contains terms for pre-existing intangible property rights and royalty payments in return. These royalty payments are taxable income in the India. The current issue surrounding the sale and transfer of intangible property is how to accurately value the transaction. Without an accurate value, an appropriate arm's length payment or royalty fees are difficult to support.

### **3.3 Cost sharing agreement**

In a cost sharing agreement, related companies agree upon how costs for developing intangible property are to be allocated between them. With this agreement, if for example, a patent was produced by the parent, the foreign principal has the rights to use that patent for a portion of developmental costs. There are tax incentives because if the parent is located in a higher tax jurisdiction than the principal and the developmental costs are less than market-based royalty fees, the corporation can decrease its global tax liability.<sup>35</sup> Nonetheless, it is often alleged that corporations are shifting cost and risks under transactions to violate the arm's length standard.<sup>36</sup>

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35 Dye, Ronald A., "Cost-Sharing Agreement A tax-saving device of multi-nationals," "Valuation Issues for Buy-In Payments Associated with Cost-Sharing Agreements" Kellogg School of Management, 2008.

[http://insight.kellogg.northwestern.edu/index.php/Kellogg/article/cost\\_sharing\\_agreements](http://insight.kellogg.northwestern.edu/index.php/Kellogg/article/cost_sharing_agreements)

<sup>36</sup> In the industrialized world, transfer pricing is the leading international tax issue. *See* CYM H. LOWELL ET AL., U.S. INTERNATIONAL TRANSFER PRICING ¶ 11.03(3) & n.186 (2005). Transfer pricing is also the most significant tax issue in many developing economies, such as China. *See* KhoonmingHo & Jean Li, *China*, WORLD TAX 2005, at 116, 122 (2005).

#### **4. THE COMPLEXITY OF INTELLECTUAL PROPERTY ISSUES**

The use of the arm's length standard in transfer pricing regulations is a major problem and may be the root of all transfer pricing issues. All transfer pricing disputes arise over the arm's length standard principal. In court, corporations will support related party transfer prices and allocations with unrelated transactions, believed to be within arm's length. The TPO would argue that the unrelated transaction is not arm's length because of a difference in quantity, market price, type of customer, packaging and other non-monetary factors.

Once the arm's length standard is found to be violated, the TPO can adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income. However, certain transactions are unique and no comparable unrelated transaction exists, a level of ambiguity surrounds the arm's length standard. Especially with transactions concerning intangible property, many times no comparables exist because of their nature.

This part discusses various challenges in taxing IP. The challenges include wide variance in the valuation of IP, accounting standards that fail to recognize the existence of IP, and the difficulty faced in determining the revenue attributable to various IP for tax purposes.

##### **4.1 Bundling of IPs**

The commercial practice of bundling IPs together for sale presents a problem for understanding transfer pricing adjustments in this context. An MNE Group often conveys licenses of IP rather than selling

underlying property rights.<sup>37</sup> Licenses of IP rights often package several patents and “know-how” together as “technology licenses.”<sup>38</sup> This transaction allow affiliated foreign MNEs to use the IP developed or owned by another related or affiliated MNE, subject to the MNE Group’s strategic plans and restrictions.<sup>39</sup> The complexity of valuing individual IP usually increases with strategies for various sophisticated licensing arrangements and cost sharing agreements.<sup>40</sup>

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<sup>37</sup> See OECD Guidelines, *supra* note 1, at VI-7, ¶ 6.16. See generally PHILIP MENDEZ, TO LICENSE A PATENT—OR, TO ASSIGN IT: FACTORS INFLUENCING THE CHOICE (n.d.), available at [http://www.wipo.int/export/sites/www/sme/en/documents/pdf/license\\_assign\\_patent.pdf](http://www.wipo.int/export/sites/www/sme/en/documents/pdf/license_assign_patent.pdf).

<sup>38</sup> See OECD Guidelines, *supra* note 1, at VI-7, ¶ 6.18. See generally Ethan Horwitz, *Patent & High Technology Licensing*, in PATENT & HIGH TECHNOLOGY LICENSING 57, 62-63 (Ethan Horwitz & Mark S. Holmes eds., 2005).

<sup>39</sup> See generally Marina Lao, *Unilateral Refusal to Sell or License Intellectual Property and the Antitrust Duty to Deal*, 9 CORNELL J.L. & PUB. POL’Y 193 (1999). A license may have various limitations, which may be based on geographic use, type of product, or channels of trade. An “exclusive license” gives permission to one party only. See ELIZABETH D. HOCHBERG ET AL., E-Z REVIEW FOR INTELLECTUAL PROPERTY 331 (2003).

<sup>40</sup> “Cost sharing” or “cost contribution agreements” are another common arrangement for importing the value of IP when two or more controlled taxpayers jointly develop the IP. See OECD Guidelines, *supra* note 1, at G-4. They are also known as “cost sharing arrangements” in the United States. Cost contribution arrangements are often interpreted differently by different countries. See Clark

## 4.2 IP Valuation

Valuation of the IP represents another reason for various disputes between the taxpayers and tax department. Even the Organisation for Economic Co-operation and Development (OECD) Guidelines recognize that it is often difficult to attribute a distinct value to each piece of IP on an ongoing basis.<sup>41</sup> Determination of the true value of IP is complex because the economic value of IP is primarily determined by the economic and legal environment in which the IP is embedded, the market demand for the IP, and the existence or absence of close substitutes.<sup>42</sup> IP often fluctuates in value significantly depending upon the key assumptions of the inherent risks associated with the IP. These risks can include liability concerns or the possibility that competitors will create new and better products.<sup>43</sup>

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Chandler & Richard Boykin, *Transfer Pricing: Introduction*, INT'L TAX REV., July 2004 Supp., at 3.

<sup>41</sup> The OECD is an international organization of thirty member countries primarily dominated by European countries. The OECD proposes government policies in various areas including transfer pricing. *See* About OECD, <http://www.oecd.org>.

<sup>42</sup> Patents are sometimes acquired to block the development of close substitutes, prevent other companies from using the technology, or for advantage in cross-licensing arrangements.

<sup>43</sup> GlaxoSmithKline's description of its competition recognizes that "[p]harmaceuticals may be subject to competition from other products during the period of patent protection and, once off patent, from generic versions." GSK ANNUAL REPORT, *supra* note 6, at 22; *see also* CANADIAN REVENUE AGENCY, PUBL'N NO. 87-2R,



The valuation of IP poses difficulties for transfer pricing decision making and government oversight for following three major reasons.

- a) comparables for such assets seldom exist. Patents are rarely traded on external markets. Usually MNEs are unwilling to sell their patents, but might license out some of the rights to use the intangible asset.
- b) Second, IP rights are often transferred in combination with tangible assets or services, known as “embedded intangibles.”<sup>44</sup> Buyers may want to acquire a product that relies on a combination of IP and other assets.
- c) Third, intangibles other than patents are particularly difficult to detect because they are not reported in financial statements.<sup>45</sup>

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INTERNATIONAL TRANSFER PRICING 15, ¶ 141 (1999), available at <http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2re.pdf>.

<sup>44</sup> See generally Richard L. Doernberg, *Taxation Silos: Embedded Intangibles And Embedded Services Under U.S. Law*, 41 TAX NOTES INT’L 561 (2006).

<sup>45</sup> Intangibles are tracked by certain proxies such as royalties, license fees, and dividends. *Id.* More than seventy-five percent of all private R&D expenditures worldwide are accounted for by MNEs. Most royalties, licenses, and management fees are intra-firm payments flowing from foreign affiliate MNEs to the parent corporation MNE. *Id.* (citing Lorraine Eden et al., *The Production, Transfer, and Spillover of Technology: Comparing Large and Small Multinationals as Technology Producers, in SMALL AND MEDIUM SIZED ENTERPRISES IN THE GLOBAL ECONOMY* 121, 122 (Zoltan J. Acs & Bernard Yeung eds., 1999)).

### **4.3 Accounting**

In addition to the above complexities associated with transactions and valuations, it may also be noted that the standards for financial accounting for IP are usually inadequate. IP generally does not appear on an MNE Group's balance sheet unless acquired through a purchase, in which case the IP appears only as "goodwill because the accounting standards in most countries allow internally-generated IP to be expensed rather than capitalized as investments. IP is generally not recorded or disclosed in an MNE Group's financial statements or its footnotes. Even if an MNE Group measures its IP, very little disclosure about IP is required in the financial statement footnotes.

## **5. VALUATION APPROACHES FOR TRANSFER PRICING OF IP**

From the above discussions, it is evident that valuations of the IP and determination of the transfer prices in IP transactions are complex and difficult task. A major area of dispute is determination of "Arm's-length standard"<sup>46</sup> being test for determining an MNE's true taxable income and appropriate transfer prices. At this stage, it is advisable that MNEs must use an approved transfer pricing method to test whether controlled transactions satisfy the arm's length standard. The transfer pricing method used for IP should reflect the modern commercial reality. In the following text, there is a discussion regarding various approaches for determining the correct value for determining the price of IP.

### **5.1 Transactional approach**

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<sup>46</sup> Theoretically an arm's-length transaction is one where the result is the same as if independent parties had negotiated a price to buy or sell the product

One type of transfer pricing approach is the transactional approach. This approach examines transfer prices on a transaction by transaction basis does not consider the aggregate financial impact. There are different methods within the transactional approach. The method referred to as the “comparable uncontrolled price” (CUP) uses a price that an outside party would charge the MNE for the item under similar circumstances.<sup>47</sup> This method is the most commonly used method worldwide to support the transfer prices of IP rights, such as a licensing agreement on a patent.<sup>48</sup>

Comparability is essential for a transactional method to provide a reasonable and reliable benchmark for evaluating an arm’s-length

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<sup>47</sup> The OECD suggests the major traditional transactional method for IP is the comparable uncontrolled price (CUP). *See* OECD Guidelines. Two other traditional transactional approaches to transfer pricing authorized by the OECD are the resale price method and the cost plus method. In practice, these two methods are rarely used for IP because of the uniqueness of most IP. *See* ERNST & YOUNG, TRANSFER PRICING 2003, *supra* note 7, at 18. The OECD Guidelines prefer traditional transactional methods. OECD Guidelines.

<sup>48</sup> Most MNE parent corporations claim to use a single set of transfer prices for all purposes. *See* ERNST & YOUNG, TRANSFER PRICING 2003 GLOBAL SURVEY 17 [hereinafter ERNST & YOUNG, TRANSFER PRICING 2003]. However, two different transfer prices are used by a growing number of MNE Groups. *See* Chongwoo Choe & Charles Hyde, Multinational Transfer Pricing, Tax Arbitrage and the Arm’s Length Principle 1 (Sept. 24, 2004) (working paper, available at <http://ssrn.com/abstract=600881>) (describing how some companies use one transfer price for internal managerial purposes and another for tax purposes)

result.<sup>49</sup> Finding comparable IP, however, is often difficult or impossible because of the nature of IP itself.

Finding comparables for IP is “at best an incomplete exercise and at worst completely subjective.” Thus, there is a frequent need to rely on hypothetical transactions in identifying comparable IP for similar products with similar profit potential. Governments sometimes create such fantasy commercial transactions by using comparables not publicly available, known as “secret comparables.”<sup>50</sup>

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<sup>49</sup> Traditional transactional methods use various factors to determine comparable circumstances for arm’s-length consideration, such as the prevailing industry earningsrate and contractual terms for the transfer of any IP rights. Commercial practices, economic principles, or proper statistical analyses provide a basis to adjust for material differences between controlled and uncontrolled transactions. *Id.* As an example, the European Union expects a comparability analysis to include a description of the property or services, functional analysis, contractual terms, economic circumstances, and specific business strategies. *See* Council Resolution 9738/06, annex ¶ 5.2(c), 2006 O.C. (405) 5 (EU)

<sup>50</sup> A Government’s use of “secret comparables” is a controversial practice that undermines the transparency in the country’s tax law. However, many governments, such as those of Japan, Canada, Korea, and Mexico, use secret comparables to prevent abusive tax avoidance through transfer pricing manipulation. *See, e.g.,* Martin Przysuski, *Canada Reaffirms Use of Third- Party Information for Transfer Pricing Audits*, 34 TAX NOTES INT’L 205, 205 (2004). France, China, Germany, and India have also used secret comparables. Lubna Kably, *Taxmen Flash “Secret Data” to Challenge Companies’ Pricing Claims*, ECON. TIMES (India), Nov. 3, 2004, available at <http://economictimes.indiatimes.com/articleshowarchive.cms?msid=908618>

## 5.2 Valuation approaches

Another type of transfer pricing approach is the valuation approach. The valuation approaches to transfer pricing best satisfy the arm's-length standard for transfer prices of IP and most closely resemble realistic commercial practices in transferring IP. The valuation approaches for IP based on net worth appear less susceptible to transfer pricing disputes than traditional transactional approaches. Various valuation methods exist to determine the transfer pricing of IP.

- a) The “comparable profits measure”<sup>51</sup> (CPM) determines the arm's-length price of a controlled transaction by reference to profit level indicators such as financial ratios from transactions in the same industry.<sup>52</sup>

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<sup>51</sup> While an economist makes numerous adjustments to establish a CPM, there are three different ways to calculate the CPM : (1) the “CPM with Berry Ratio” (gross profit to operating expenses), (2) the “CPM using an Operating Margin,” and (3) the “CPM using a Three-Year Rolling Average Operating Margin.”

<sup>52</sup> Comparability under the CPM is less strict than other methods, resting primarily on resources employed and risks assumed. *See generally* Anthony Barbera & John Hatch, *CPM and Determining Income Attributable to Intangible Assets*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 40 (2004). Significant product diversity and functional diversity of the MNE activities for the product are accepted under the CPM. Usually a government prefers that comparable parties operate within the same industry segment as the controlled party. Treas. Adjusting for differences in accounts receivable or payable are

- b) In contrast, the “profits split method”<sup>53</sup> looks at the combined profit or loss from a business activity between controlled parties and allocates it between the related parties based on a preset formula.<sup>54</sup>

Valuation methods other than these two may be used if the alternate method provides the most reliable measure of an arm’s-length result. Valuation approaches are needed for regulating transfer pricing of IP because the value of IP is difficult to measure on a transaction by transaction basis.

The governing standard for transfer pricing methods in the India is the “best method rule,” which utilizes various criteria, such as the requirement that data be comparable and reliable, to evaluate the valuation methods.

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examples of accounting adjustments to ensure greater consistency for comparability.

<sup>53</sup> It essentially allocates income based on IP development costs and is widely used in transfer pricing studies for MNEs. *See* Langbein, *supra* note 181, at 1313. Concern exists about the heavily-weighted use of the RSPM in the proposed 2003 regulations. Michael Heimert, *A Systematic Approach to IP Transfer Pricing*, INT’L TAX REV., Jan. 14, 2005, at 37, 39.

<sup>54</sup> The formulary apportionment allocation may be based on the relative value of each party’s business activity for the combined venture.

## 6. POSSIBLE SOLUTIONS

General framework of “internationalization” would be held full at the policymaking level for authorizing transfer pricing methods. There has to be international cooperation to exchange information. Mechanisms may be created for resolving international disputes, as has occurred with the WTO and international IP law.<sup>55</sup> Harmonization of definitions and provisions in an area such as patent law would also help the cause.<sup>56</sup>

There are also suggestions that major international legal reforms are required to effectively reduce tax avoidance by MNE Groups. It proposes to levy a minimum tax into the current international treaties on IP registration to prevent MNE Groups from escaping significant tax on their IP. It further proposes to adopt uniform and all-inclusive

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<sup>55</sup> The WTO has the WTO Appellate Body, which oversees the work of all WTO dispute resolution panels. *See* G. Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the WTO*, 44 DUKE L.J. 829, 831- 34, 848-53 (1995).

<sup>56</sup> Sources on external comparables arise from (1) confidential information from third parties often referred to as secret comparables, (2) public information such as industry surveys, and (3) databases that compile information supplied by the MNEs. *See* OECD, *Comparability*, Comparables are usually located using public databases. *See generally* Mildred A. Hastbacka, *Valuation of Technology Intangibles for Transfer Pricing: Time for Industry Initiatives?*, 32 TAX NOTES INT’L 265, 272 (2003).

multiple ownership rules for IP to identify the MNEs rightfully subject to taxation as IP owners.<sup>57</sup>

## CONCLUSION

The Transfer pricing regulations have many gray areas that have resulted in various disputes and litigations. It is often alleged that tax avoidance through transfer pricing manipulation of IP, along with the movement of IP to tax haven countries, has created a need for legal reforms in IP transfer pricing regulation. Along with the valuation of IP, the arm's length standard itself is the core of current transfer pricing problems because many time comparables simply do not exist in IP transactions. Though there are suggestions for the determination of the true value of the IP in such situations.

Undoubtedly, the jurisprudence on the issue is evolving, and current laws and regulations have flaws and are not perfect. Valuation of IP transactions will never be a perfect science. However, regulations governing the IP transactions ought to ensure that IP is being shifted for commercial reasons and not solely for tax evasion.

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<sup>57</sup> THOMAS C. PEARSON, Proposed International Legal Reforms for Reducing Transfer Pricing Manipulation Of Intellectual Property, presented at the 18th Asian-Pacific Conference on International Accounting Issues on October 16, 2006