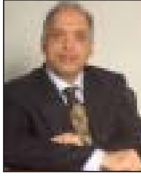
SPECIAL STORY



International Decisions on Transfer Pricing

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The pace of cross border transactions, advent of e-commerce, offshoring, remote processing and the ability of MNEs to shift their employees, know-how, capital and even head quarters overseas and with them their profits, creates unease among governments, as each nation zealously guards its tax base. It is this which has lead to the evolution of transfer pricing, as a means of safeguarding a country's tax base. If each arm of an MNC prices its "intra group transaction at arm length than each jurisdiction would get its fair share of taxes".

The aim of all nations to protect their tax base has to be finely balanced. The OECD Guidelines (Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations) tries to enunciate international standards and concepts to achieve this fine equilibrium, which forms the backbone of the Transfer Pricing Regulations (TPR) worldwide. This has helped to create global standards for Revenue Authorities (RA) to correctly assess the effect of the transfer pricing policies of Multinational Enterprises (MNEs) with the aim to attribute arm's length profit in their jurisdiction, based on the separate entity approach.

The importance given by the nations to transfer pricing, has led to the strict administration by the revenue authorities (RA) of the TPR across the world, and has consequently thrown up interpretational issues of great importance. The RA globally are focusing on transfer pricing, adherence to the arm's length principle and the importance of documentary substantiation. This trend has seen vast resources being invested by the nations, in their endeavour to strengthen the administrative set up, the aim being to collect taxes if the MNEs controlled transactions are not at arm's length (AL).

Amidst this backdrop, this article analyses certain international case laws, to bring out certain nuances which could find application in India as regards Transfer Pricing.

The true method of studying case law is 'to get at the heart of the law, to grasp with clearness the main outlines of its history, and to lay hold of its main principles.' One must follow the development of the main principles and note the effect of each decision thereon, and with this object in view the case laws have been analysed. Though no doubt there is some difference between the transfer pricing rules in the US and India but this is mainly in matters of detail and procedure. The fundamental principles of the transfer pricing regulations are to a great extent the same worldwide and the US decisions are of great help when questions of real difficulty have to be solved, and thus could have bearing on the evolution of the interpretation of the Indian TPR.

Analysis of foreign court decisions

1. *Hospital Corporation of India vs. Commissioner of Internal Revenue*

Facts

Hospital Corporation of America (hereinafter referred to as "HCA") was in the business of

owning and/or managing hospitals. HCA maintained its principal offices in Nashville, Tennessee, USA. During the years before the Court, HCA generally had a separate domestic subsidiary corporation to operate and manage each hospital it owned and had another domestic subsidiary for all of the hospitals it managed under management contracts with the owners thereof. The management contract were generally entered into by "HSP Inc" a subsidiary of HCA. Until 1973, HCA's organization operated exclusively in the United States and HCA and its subsidiaries filed a consolidated US Corporation Income Tax Return.

In late 1972 after an initial contact by a certain finder, HCA gave a "hunting licence" to that finder to pursue an opportunity for a contract to manage a hospital in Saudi Arabia. In February of 1973, after introductions by that finder, HCA was invited to send representatives to Saudi Arabia to discuss the possibility of contracting to manage the King Faisal Specialist Hospital (hereinafter KFSH or the King Faisal Hospital), which was then under construction in Riyadh, Saudi Arabia. The KFSH, owned by the Royal Cabinet of the Kingdom of Saudi Arabia, was intended to be equipped with the latest in sophisticated computers and medical equipment and to be a showcase or the "Mayo Clinic" of the Middle East. HCA made preliminary investigations as to the potential profit and prestige of contracting to manage the KFSH and decided to pursue the opportunity. HCA decided at the outset that it would not become directly involved in international operations but would organize foreign subsidiaries for any foreign expansion. It therefore organized two corporations in the Cayman Islands. Tax consequences were considered in making the decision to incorporate in the Cayman Islands. These Cayman Islands corporations were organized as first and second tier subsidiaries of HCA. The first tier subsidiary was Hospital Corporation International, Ltd. (HCI One), and the second tier subsidiary was Hospital Corporation of the Middle East, Ltd. (LTD). The names of these corporations were later changed to Hospital Development Company, Ltd. (HCI One) and Hospital Corporation of America, Ltd. (LTD).

HCI One was formed to be an umbrella corporation for any expansion into foreign countries. LTD was formed specifically to obtain and perform the management contract for the King Faisal Hospital.

On August 26, 1973, LTD and the Royal Cabinet of the Kingdom of Saudi Arabia executed a management contract. HCA did not include any of the income earned from the KFSH management contract on its 1973 tax return. This case involved only the adjustments for this foreign income for the year 1973.

The Commissioner contended that HCA had used a type of inter company account for its domestic subsidiaries for allocation to the subsidiaries of expenses incurred in the Nashville headquarters. Overhead expenses incurred in Nashville were then reflected in both the subsidiary's and HCA's records but this allocation was simply made by means of a management fee based on estimated patient days at a particular hospital. The record did not establish that the management fee based on estimated patient days clearly reflected the expenses of the services rendered by the parent company. Other than the above accounts, no evidence was presented that HCA, in 1973 maintained any formal inter-company accounts to reflect the services rendered by the parent corporation to its domestic subsidiaries. The record also did not indicate the type of records maintained by HSP Inc in regard to the non-HCA owned hospital operated under management contracts or whether there were any formal inter-company accounts for services rendered by the parent corporation to those hospitals.

The Commissioner's primary argument was that LTD was a **sham corporation** and therefore all income derived from the KFSH management contract in 1973 was in fact earned by HCA and taxable to it under section 61. It could not be recognized for Federal income tax purposes. Commissioner asserted that LTD was "a mere skeleton; a sham corporation that existed in form only for the purpose of obtaining the tax benefits available to a foreign corporation." Commissioner argued that the fees earned from the KFSH management contract were produced by HCA's professional skill, expertise, know-how, reputation, goodwill, experience, business organization, and procedures and were therefore taxable wholly to HCA under section 61.

Commissioner maintained that in substance the income from the KFSH management contract was earned by HCA, not LTD.

The Commissioner also asserted that the only reason HCA organized LTD in the Cayman Islands was to avoid United States corporate income tax on the fees earned under the KFSH management contract.

The Tax Court held that that Commissioner in his zeal regarding the Cayman Islands' status as a tax haven, had failed to address the fact that LTD would not have been taxable if it had been organized in Saudi Arabia since King Faisal had exempted this contract from any corporate tax. HCA's officers testified that there were several reasons for choosing the Cayman Islands as the jurisdiction for incorporation rather than Saudi Arabia. Among these reasons were the use of the English language, the familiar English principles on which Cayman Islands corporate law was based, the stability of the government, and the ease of communication and transportation between HCA's headquarters in the United States and the Cayman Islands. HCA had also admitted that one of the reasons it incorporated LTD in the Cayman Islands was that the Cayman Islands did not impose an income tax on corporations registered under section 179 of the Cayman Islands Companies Law.

However HCA proved by a preponderance of the evidence that LTD actually carried on some minimal amount of business activity in 1973. LTD was properly organized under the Companies Law of the Cayman Islands. In 1973 LTD issued stock, elected directors and officers, had regular and special meetings of directors, had meetings of shareholders, maintained bank accounts and invested funds, had at least one non-officer employee, paid some expenses, and, with substantial assistance from HCA, prepared in 1973 to perform and in subsequent years did perform the KFSH management contract. All of these are indicative of business activity. Moreover, LTD's identity was recognized by entities not controlled by HCA. In 1973 LTD received management fees of $ 1,874,984 from the King Faisal Hospital management contract. It incurred some operating expenses and had a substantial profit from operations that year. During 1973 LTD made some cash payments to HCA to reduce an inter-company account.

HCA also contended that these payments were further indications that LTD carried on some modest amount of business in 1973. Commissioner's contention that LTD was a sham was based primarily on his assertion that HCA could have negotiated and performed the contract itself. The fact that these same individuals were also officers and directors of HCA was not sufficient reason to disregard the corporate existence of LTD.

The Tax Court concluded that it was not a sufficient reason to disregard the corporate existence of LTD.

The Commissioner's second argument was that the management contract was negotiated by HCA and then transferred to LTD without obtaining the advance ruling required by section 367. However for the purposes of this

chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 per cent of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporation equal in value to the fair market value of the property transferred unless, before such transfer, it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Commissioner specifically argued that HSP, Inc., a domestic subsidiary that performed other management contracts, could have been selected by HCA to perform this contract.

The Tax Court held that. HCA, in presenting LTD with an opportunity to enter into a contract, did not transfer any legally enforceable contractual or other right to LTD. Instead, in discovering this business opportunity and making it available to LTD, HCA simply performed a service for which it was entitled to reasonable compensation. Hence HCA did not transfer any property to LTD so a section 367 ruling was not required.

Commissioners third argument was HCA received stock in LTD for services rendered in negotiating the contract and for services to be rendered in the performance of the contract value of the stock HCA received as compensation for services is equal to the entire value of the management contract, less LTD's paid-in capital.

HCA argued that in fact it owned no stock in LTD directly so it did not receive any stock as compensation for services. LTD's stock was issued to HCI One, HCA's first tier subsidiary in the Cayman Islands, "for cash at par, not to HCA." Moreover, HCA asserts that LTD had paid "over $ 8,000,000 as compensation for services" HCA performed for LTD during 1973-80.

The Tax Court contended that HCA's receipt of stock in exchange for services was not mentioned in Commissioner's statutory notice of deficiency. It was thus a "new matter" within the meaning of Rule 142(a). Commissioner bears the burden of proof and had not carried that burden. Commissioner had not persuaded that the determination of the value of the contract was correct. Also Commissioner had not persuaded that the present value of the entire KFSH management contract properly measures the value of HCA's services to LTD. "We think this represents another attempt by the Commissioner to disregard the separate corporate existence of LTD." In any event, "we think this case is more properly analyzed under section 482 and we hold that section 482 requires an allocation of a portion of LTD's income to HCA because of services it performed in negotiating the contract and assistance it provided to LTD in performance of the contract."

Commissioner's final argument was that all of LTD's taxable income for 1973 in the amount of $ 1,787,030 should be allocated to HCA pursuant to section 482.

The Tax Court contended that the Commissioner was justified in doing so as section 482 permits the Commissioner to examine dealings between controlled corporations and make allocations so as to place these dealings on the same basis for tax purpose. However, the Commissioner allocated 100 % of LTD's taxable income to HCA.

The Tax Court held that Commissioner's action to allocate 100% of LTD's income was erroneous but however some allocation was necessary for use of intangibles belonging to HCA, and concluded that 75% of the taxable income of LTD in 1973 was attributable to

HCA and therefore Commissioner erred in allocating the remaining 25% to HCA.

Issue

1. Whether the Cayman Islands subsidiary was a "sham" corporation so that all of its income for the year 1973 is attributable to Hospital Corporation of America under section 61 of the Internal Revenue Code
2. Whether property in the form of the contract to manage the King Faisal Specialist Hospital in Riyadh, Saudi Arabia was transferred by Hospital Corporation of America to its Cayman Islands subsidiary in 1973 without obtaining an advance ruling pursuant to section 367;
3. Whether Hospital Corporation of America received stock in its Cayman Islands subsidiary as compensation for services; and
4. Whether some or all of the 1973 income of the Cayman Islands subsidiary should be allocated to Hospital Corporation of America under section 482.

Ultimate findings of the Tax Court

1 Hospital Corporation of America, Ltd., was not a sham corporation and was to be recognized for Federal income tax purposes;

2. The management contract for the King Faisal Hospital was not obtained by HCA and then transferred to its Cayman Islands subsidiary, Hospital Corporation of America, Ltd., within the terms of section 367; and

3. Seventy five (75) per cent of the 1973 net income of Hospital Corporation of America, Ltd., was allocable to HCA under section 482.

Ratio of the case law

1. That it is prudent to establish the commercial and business reasons for setting up corporations in low tax jurisdictions. The tax-payer would need to thus establish the rationale and depict the economic substance of such corporations, to avoid the Revenue from "looking through" such corporations.
2. That from a transfer pricing perspective the action of an associated entity would require to be judged from a stand point of independent entities transacting in the market place. Hence from a Multinational Group perspective actions which would be for a common good, would perforce be required to be broken down, in a manner whereby each corporation of the group would be attributed an arm's length return for its activities carried out, subject to the risk undertaken and tangible and intangible assets contributed. Thus, though the tax-payer could avoid the argument of LTD being a "sham" corporation, transfer pricing adjustment could not be avoided, which to some extent—nullified the defence of the tax-payer, regarding the business purpose of LTD.
3. Thus, while structuring the international transactions, if the principles of transfer pricing are not given effect to, there is risk on the MNE.

2. Bauch & Lomb vs. Commissioner of Internal Revenue

Facts

In 1978 B & L was a major participant of the soft contact lens industry, controlled nearly about 50.6% of the US market. The manufacturing plant was situated at Rochester, US. B & L considered going global

and evaluated various alternatives, including setting up manufacturing operations overseas. Considering the various incentives offered by the Industrial Development Authority of the Republic of Ireland. ("IDA"), including a tax-holiday on all export profits, B & L established a manufacturing facility in Waterford, Ireland.

The Tax Court believed that B & L had sound business reasons for the establishment of B & L Ireland. Further B & L demonstrated that it was prudent to establish additional manufacturing capacity overseas in order to minimize regulatory delays and also to have a facility capable of serving the increasingly important European markets. Hence Ireland was determined to be the location where these objectives could be realized most cost effectively due to the incentives offered by the IDA

B & L Ireland was incorporated on February 1, 1980. B & L, B & L Ireland, and IDA entered into an agreement that specified the incentive to be provided for the venture by the IDA and the reciprocal commitments undertaken by B & L and B & L Ireland. B & L Ireland agreed, *inter alia*, not to enter into any royalty commitments, except that B & L Ireland could pay royalties to B & L or any subsidiaries in an amount not to exceed five percent of B & L Ireland's annual net sales.

B & L in 1960s had obtained nonexclusive rights to use the patents secured on the "spin cast" technology which were developed by a Czechoslovakian chemist. B & L also acquired two machines. Later B & L made several modifications that increased the yield to a commercially acceptable level. In 1981 B & L granted B & L Ireland a non exclusive license to manufacture lenses using B & L's spin-cast technology. In addition the licence agreement entitled B & L Ireland to any improvements resulting from B & L's ongoing research and development in the manufacture of contact lenses and permitted B & L Ireland to sell contact lenses anywhere under B & L's trademark. In exchange, B & L was to receive a royalty of 5% of the subsidiaries net contact lens sales. The agreement was terminable upon the written notice of either party.

B & L Ireland began all manufacturing, processing, packaging, labelling and inspecting functions at its Waterford facility. B & L was under no contractual obligation to purchase any lenses from B & L. The inter-company transfer price was $ 7.50 per lens. The purchaser also paid the duty and freight charges, which in the case of B & L was $ 0.62 per lens.

Revenue's stand

The Commissioner was of the view that the consideration for the use of B & Ls intangible assets by B & L Ireland would be a net profit before taxes of 20% sales. The Commissioner's contention was that it would be inappropriate to analyze the transfer price and royalty rate used by B & L separately. The Commissioner argued that B & L would never have agreed to licence its spin cast technology which allowed it to produce soft contact lenses for approximately $ 1.50 per lens and then purchase lenses from the licensee for $ 7.50 per lens. The Commissioner argued that B & L would have been unwilling to pay an independent third party much more than it would cost it to produce, had it chosen to produce the contact lenses itself. The Commissioner was indifferent as to whether the royalty was increased or the transfer price was decreased as long as the result was that B & L Ireland received only its costs of production and a reasonable mark up. In essence the Commissioner argued that B & L Ireland was little more than a contract manufacturer the sale of whose total production was assured and who thus was not entitled to the return normally associated with an enterprise which bears the risk as to the volume of its product it will be able to sell

in the market, thus subject to market risk and at what price.

Issues

1. Determination of the transfer price paid by the US Parent Corporation to its Foreign Subsidiary for contact lenses, whether such price adhered to the arm's length standard.
2. Royalty paid by subsidiary to its parent for the use of its manufacturing technology and related intangibles possessed by the parent.

B & L filed a petition to the Tax Court for re-determination of the deficiencies.

Tax court ruling

The Tax Court determined that the transfer price that B & L paid to B & L Ireland for lenses and the royalty rate that B & L Ireland paid to B & L for use of its manufacturing technology and related intangibles had independent significance, and thus should be examined separately. The court was also of the view that its determination could be sustained under the alternative resale price method. Second, the court rejected the royalty rates suggested by each side and, drawing upon the expert testimony presented by the parties as well as other evidence in the record, concluded that reallocation should be based upon a royalty rate equal to twenty per cent of B & L Ireland's net sales. The Tax Court premised its ruling upon numerous sales by four different lens manufacturers to unrelated lens distributors. All comparable sales prices were reduced by $ 0.62, an adjustment that compensated for B & L's unique practice of paying the duty and freight charges on its lens purchases. After this adjustment all these sales were at a price that exceeded the $ 7.50 transfer price paid by B & L, with one exception. One manufacturer, the Amsco/Lombart division of the American Sterilization Company, transacted some sales (less than half) that, when adjusted, indicated a transfer price less than $7.50 but, the Tax court gave these sales little weight because, unlike the uniform price charged by B & L Ireland, they set different prices for standard and thin lenses. All other adjusted comparable sales, including Amsc/Lombart single price sales, indicated a transfer price above $ 7.50, with many exceeding $ 10.

The Commissioner further contended that in addition to its distribution functions, B & L "supplied the know how necessary to manufacture the lenses, the Bausch & Lomb and Soft lens trademarks, the FDA approval required for sales in the United States market, the fruits of its ongoing research and development, and ready made foreign and domestic markets.". The position urged by the Commissioner would preclude comparability precisely because the relationship between B & L and B & L Ireland was different from that between independent buyers and sellers operating at arm's length. The commissioner thus tried to bring out the economic profile of B & L's operations vis-à-vis B & L Ireland. This depicted that B & L did not function as a mere reseller and actually created lot of value by its business operations for B & L Ireland.

To determine the royalty rate for B & L's intangibles the regulation provides two methods for determining an arm's length price for the transfer or use of intangible property. If the transferor has made similar transfer to unrelated parties, the amount of consideration for such transfers generally would be the best indication of an arm's length consideration. In the absence of adequate similar transaction the arm's length consideration may be determined with reference to a list of applicable factors.

The court then examined the 1981 licensing agreement which provided that B & L Ireland would pay royalties to B & L in the amount of five per cent of B & L Ireland's total sales. Conceding that this royalty was unreasonably

low B & L presented expert opinions at trial that an arm's length consideration would have been five per cent of the average price realized by B & L and its subsidiaries ("Group") upon the sale of the lenses to unrelated third parties. The Commissioner's experts calculated a much higher rate between twenty seven and thirty three percent of the Group Sales.

Decision

The Tax Court rejected the positions presented by both parties' experts. Concluding that there were no sufficiently similar transactions upon which to base an arm's length rate, the court focused on two of the factors listed in the applicable regulation: the "prospective profits to be realized by the transferee through its use of the property," and the "capital investment and start up expenses required to be incurred by the transferee."

The Tax Court made two adjustments to the projections in order to reflect the approach of a "prudent investor" in the circumstances. First, the court reduced the projected output at the Waterford facility during the years 1986 through 1989 to account for anticipated "erosion in the demand for both standard and thin lens sales as prolonged wear lenses made of new materials became available." Second, the court made reductions in projected transfer prices for 1983 and beyond on the basis that lower cost competitors would enter the market and drive down prices.

Thus the court contended that that at arm's length B & L Ireland would have been willing to invest in the lens production facility even if required to share approximately 50 per cent of the profits there from with B & L as consideration for use of its intangibles which equated to a royalty rate of 20 per cent of B & L Ireland's net sales.

Ratio of the case law

1. This case thus brings out the importance of documenting in detail the economic profile of the associated entities. Thus, though the revenue may not have succeeded in reducing the selling price of export sales by B & L Ireland, it was able to increase the royalty rate, and thus, to a limited extent indirectly reduce the export price of B & L Ireland.
2. Further, the case also sheds light, that one has to see that full gamut of all the international transactions, and evaluate them, to determine whether they adhere to the arm's length standard or not.

3. *Sundstrand Corporation and Subsidiaries vs. Commissioner of Internal Revenue*

Facts

"SunPac" was a wholly owned subsidiary of Sunstrand Corporation (Referred to as "Sunstrand"). The subsidiary was located in Singapore. The central issue was the correctness of certain adjustments and allocation made by the Commissioner. The Commissioner determined that the prices at which SunPac sold its products to Sunstrand during the years at issue – 1976, 1977, 1978 were not at arm's length.

However Sunstrand contended that such prices were at arm's length.

The Commissioner in the process requested Sunstrand to submit financial information for post taxable years financial data.

Sunstrand agreed to disclose the 1976, 1977, 1978 documents as described in the proposed stipulation. However it questioned the relevancy of certain data that related to taxable years subsequent to those in the issue.

Sunstrand therefore filed a petition (motion in limine) to exclude evidence relating to the post taxable years financial data as it would needlessly and geometrically expand the scope of both the stipulations and trial.

The Commissioner contended that the data would be useful in increasing the Courts knowledge of the facts and it provide a consistent overview to confirm his contention that an inappropriate inter company pricing mechanism existed between Sunstrand and SunPac for the years in issue. The Commissioner, however, related that he did not base his determination solely on the post-taxable years' financial data nor did he intend to use this data as evidence to support a specific method of making a section 482 reallocation.

Issues

Whether post financial years data should be considered or it should be exclude.

Decision

The Tax Court upon careful consideration of both the parties' arguments agreed with the view taken by Sunstrand that post taxable year financial data should be excluded under the rule 403 Federal Rules of Evidence.

The Tax Court contended that the post-taxable years' financial data focuses on aggregate sales and profit figures. Aggregate figures for subsequent years do not bear a direct relationship to prices, sales and profits associated with the sale of any individual product in a previous year. As such, they found that the post-taxable years' financial data were of low, if any, probative value. Accordingly, evidence of post-taxable years' financial data was excluded under Rule 403, Federal Rule of Evidence.

Ratio of the case law

It may be appropriate to consider grounds of evaluation. Relevant evidence means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence. What needs to be considered is

1. Whether it is relevant or irrelevant.
2. If found irrelevant as mentioned in point 1 such evidence may be excluded if it leads to causing any of the following to the tax-payer
   - *Unfair prejudice*
   - *Misleading the jury*
   - *Consideration of undue delay*
   - *Needless presentation of cumulative evidence*
   - *Confusion of the issue*

Thus evidence which is not relevant is not admissible.

That, in this particular case the internal rules of the domestic law came to the rescue of the tax-payer.

However, considering the business dynamics of today, it is probable that one may require to take into account events happening after the year end, for justifying that the international transactions are at arm's length. Further, from an overall perspective and the way transfer pricing audits are administered, the tax-payer may be required to reveal post tax years data, for allowing the international transactions to be evaluated.

The OECD Guidelines also tend to give credence to the business and commercial realities and state that:

"Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties."

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