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ANALYSIS OF LEGAL EVASION OF TAX ON TRANSFER PRICING WITH SPECIFIC REFERENCE TO COMMERCIALIZATION OF INTANGIBLES

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ABSTRACT

The levy and collection of taxes is a not new concept for India. This system of tax collection is available from the ancient period. There are so many evidences to prove tax collection mechanism in India. Taxpayer always finds loopholes in the payment of taxes. Now days, Taxpayer are recruited tax experts to get advice, and escape from tax liability.This taxpayer activity leads to legal evasion. Tax payers have been using various holes already existing in domestic as well as international law to evade tax liability. Transfer pricing means, the price which is fixed at the time of transaction. Usually, transfer pricing is applied at the time of international or cross-border transactions. This transaction has been done among the multinational enterprise with associated enterprises. The actual loopholes are found as, commercialization issues on fixation of price or valuation of intangibles. The act of commercialization can be done after the valuation of intangibles. So, valuation of intangibles played a vital role in commercialization. Every goods or services have some value. Such value can be assessed with help of expenses incurred at the time of manufacturing, processing, inventing, creating etc., Intangible property shall be valued and final price fixed with common procedure. But, every intangible property is unique and cannotfix the common procedure in valuation. The act of valuation may fix the final price for intangibles. Organization for Economic Co-operation and Development (OECD) has clearly declared the traditional methods not useful, and recommended to apply the hard-to-value- intangible approach. Such an approach is not suitable for levy, and collection of tax on intangibles. India is not ready to apply the above-mentioned approach. Due to that, taxpayer may utilize this gap, and escape from tax liability. Researcher has put a spark on gun powder to remove the darkness in levy, and collection of tax on intangibles and remove barriers on reasonable commercialization. This loophole is phased by appropriate suggestions given by research. Government and tax authorities shall apply best methods in valuation of intangibles, and eclipse legal evasion of tax on intangibles.

Keywords: *commercialization, Intangibles, Legal evasion, Taxes, Valuation, Manufacturing.*

INTRODUCTION

A tax is a mandatory payment collected from the public, and spent for public welfare. The term of ‘Tax’ derived from Latin term taxare. It means, to assess the value of something. Taxes are accumulating crucial revenue for the government. Tax levied on income, wealth, and taxable transactions. Basically, there are two kinds of tax in India. One is direct tax and another is indirect tax. The direct tax levied by the government from the taxpayer without any intermediately. But, Indirect tax collected from consumer and paid by seller. The middle person among the government and consumer will be merchant and seller. According to the author perspective, the payment of tax shall be a duty under the constitution. The Constitutionof India does not expressly mention the duty under the heading of constitutional duty. It is a duty of citizens as well as non-citizen to pay the tax to the government. The growth of the economy can be identified by the payment of taxes. A good tax system has always played a vital role in the growth of the country.

The direct tax system may be new for India. But, it was available from the ancient period. There are some reference clearly declared that, levy and collection of tax existing from the ancient days. The references were such as, Arthasasthra and Manu Smirti. According to the Manu smiriti, the king has authority to levy and collect taxes. Initially, Sage advised the king to levy a tax on income and expenditure. The king ensured taxes cannot be over burden on the taxpayer. The taxpayer shall not feel the collection of tax. Ancient taxation system were based on the share of income. Trader shall pay 1/5th their profits as tax. The farmers are supposed to pay taxes on the share of 1/6th, 1/8th and 1/10th of their produce. It depends upon the seasons.The manu smriti clearly denotes that, existence of well established tax systems in ancient India. These taxes are not only limited to the above-mentioned peoples, and extend to singers, dancers, and actors. The medium of payment of tax collected in various forms such as, share in profits, gold coins, raw-materials etc.[1]

In kautilya Arthsastra clearly denotes that, taxation system existed from the ancient days. There were some references designated the import and export of goods. The Mauryan Empire entrusted to promote international trade and laws.

The collection of income tax was well established from the ancient days. They have followed a separate levy system in the name of Dvarodaya. There are so many evidences to express the existence of income tax system in ancient India.

The article mainly covers the various issues on the levy and collection of taxes on the intangibles. Legal evasion of taxes is one of the major problems faced by many countries. These issues can be rectified by certainty in the taxing statute. Tax is an evergreen area and updated at every financial year. Transfer pricing is an uncompleted issue in international taxation. Transfer pricing means, the price which is fixed among the associated enterprise. These associated enterprises are fixing lowest price or transferring profit to low tax countries to escape his tax liability. Commercialization and valuation is coincided. Every good and service has own commercialization. But, stage of commercialization will begin from the valuation of intangibles. The valuation of intangibles created the biggest issues in levy and collection of taxes in India. Usually, multinational companies make their indirect profit at commercialization and valuation. These issues are termed gun powder. Author wants to put some spark of fire on gun powder to be aware about legal evasion of tax on intangibles with respect commercialization.

[1] EDWIN R.A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABORD, INDIA 122 (Law Exchange Ltd 2011).

LEGAL EVASION OF TRANSFER PRICING IN COMMERCIALIZATION

Tax is a mandatory payment made by the public to the government. Government may be run based on revenue collected from the public. Revenue will be utilized for welfare of people and development measures. Government shall increase the tax base by increasing the number of taxpayers. The taxing statute is provides deduction and exemptions to tax payers.It will encourage taxpayer to pay the tax regularly. Legal evasion means, a taxpayer may evade the tax payment by invoking provisions of deduction and exemptions under the taxing statute. Commercialization of intellectual property is starting from the valuation. There are various numbers of loopholes at valuation. At the same time, taxing statute shall mention specific methods to value intangibles. But, the Income Tax Act, 1961 does not have provisions to fix the price or valuation of intangibles.[2] Therefore, it creates loopholes in charging the tax on international transactions. Transfer pricing means, the transaction takes place among the associated enterprises. They used to transfer the high tax burden country to low tax burden country. It will reduce the payment of taxes to concerned multinational companies. Simultaneously, it causes revenue losses for the government.

This issue may be easily understood by following an example: There are three companies situated in three different countries. These three companies named as company A, B and C. These companies fulfilled the definition of associated enterprises. Company A situated at India and doing following activities: research and developments for development of products, expenses incurred in the course of development of intellectual property, any advertisement or promotion expenses incurred for intangible property, any other expenses expensed to improve the intangibles property. Company A made an intangible property and invoked the deduction provisions under the Income Tax Act,1961.[3] In the mean time, company A fixed the lowest price, and the same undervalued. The actual expenditure done by the company as, 50,00,000 rupees. But, Company A sold that intangible property at the value of 10,00,000. Indirectly, Company A fixed the lowest price to evade the tax payment. Company B transferred the same intangible property to company C. The value of transactions fixed price as, 5 crore. This example clearly declared that, company A voluntarily fixed the lowest price to evade the high tax liability. These multinational companies started the branches or franchises in low tax jurisdiction countries or tax havens to evade the payment of tax.[4] It shall be regulated by invoking the proper tax system. It is the main loophole in international transactions with respect to intangible assets.

GUIDELINES OF VALUATION OF INTANGIBLES

Intangible assets have more value than tangible property. The value of intangible assets fixed on the basis of monetary value. Intangible property means, there are some specific typesof intangible properties such as, trademark, copyright, patent, industrial design, geographical indications, integrated circuit etc.

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[2] GOKUL KISHORE, TAXMANN'S CROSS-BORDER TRANSACTIONS UNDER TAX LAWS & FEMA – PRACTICAL COMMENTARY COVERING INCOME TAX(INCLUDING INTERNATIONAL TAX & TRANSFER PRICING), GST, CUSTOMS & FEMA, ETC. WITH CASE LAWS, INDIA,87 (Taxmann 2022).

[3] TAXMANN'S, INCOME TAX ACT, INDIA 167 (Taxmann's 2023).

[4] THE CHAMBER OF TAX CONSULTANS, TRANSFER PRICING- A COMPENDIUM, INDIA, 182 (Taxmann's 2022).

Every business has its own different type of intangible property. For example: if the company undergoes a research and development process to invent the new invention. According to the Patent Act, 2005, 'invention' as a new product or as process involving an inventive step and capable of industrial application.[5] Inventor may apply under the patent act to get his patent rights.

Patent means, a patent granted for any invention granted under this act.[6] Inventor has right to accumulate the expenses from creation and getting registeredunder the invention. Further, improvements made the by inventor are also supposed to intothe value of the invention. There are some following criteria to get the valuation such as, purchase of intangible property fund allocation in financial reporting, imparting test, transfer pricing price, taxation prospective at merger and acquisition, litigation, bankruptcy, and restructuring. Each type of intangible asset has a unique valuation method. The methods of valuation may the same for every intangible. There are some types of intangibles assets.[7]

CONTRACT RELATED INTANGIBLE ASSETS: Lease agreements, franchise agreements, service and supply contracts.

MARKET RELATED INTANGIBLE ASSETS: Trade mark, Service Marks and Non-compete agreement with related to trade.

ARTISTIC RELATED INTANGIBLE ASSETS: nature of assets relevant to copyright such as, musical work, literary work, and Motion pictures.

OTHER INTANGIBLE ASSETS: Patent, Geographical indication, integrated circuit and neighboring rights.

FAILURE OF APPROACHES UNDER VALUATION

Intangible assets may be taking into consideration for valuation. But such intangible assets shall fulfill the following conditions: -

- The holder of intangible assets shall have a future economic value. The absence ofvalue is considered as the non-economic benefit to the holder of intangibles.
- The cost of intangible assets shall calculated by the way of authenticated one.

The second conditions shall be complied with entries in profit & loss account of preceding years. For example: a company purchased the intangible property from the holder. Thereafter, the company invested some money to improve such intangible property in another financial year. The expenses of acquisition and improvement shall be mentioned in the relevantfinancial year. Any assets created with internal research and development. The expenses incurred by the company or organization to create such intangible property. The intangible assets may be purchased at the time of business combination or grant in aid issued by the government. In these circumstances, the fair market price shall be fixed, and entered in the relevant financial

[5] SHEETAL CHOPRA, A BOOK ON INDIAN PATENT SYSTEM AND PATENT AGENT EXAMINATION, INDIA, 45 (Notional Press, 2018).

[6] NARAYANAN.P, INTELLECTUAL PROPERTY LAW, INDIA 79 (Generic,2022).

[7] P.K.Chopra& Co, Valuation of Intangible, TAXGURU, (Feb, 29,2023, 11.24 AM)), https://taxguru.in/income-tax/valuation-intangible-assets.html

year.[8] Finally, a company or organization checks the anticipation onprospective monetary benefits. Management ensure the authentication, and support of documents on future monetary benefits. Intangible assets may be recognized by fulfill the above mentioned conditions. The supported document must be outside the managementevidence. Overall gravity shall be give to external evidence. There are three common types ofapproaches in valuation of intangibles. These approaches are based on Indian Accounting Standards 38.[9]

- Cost Approach
- Income Approach
- Market Approach

The above-mentioned approaches may be useful in valuing intangibles. But, these methods are not suitable for good will.

COST APPROACH

Act of acquisition of intangible assets

The company may invest a lump sum amount to get intangible to their business. The act of investing will reflect the future benefits from the transactions. It is also accompanied by future economic benefits. There are some lacunas in consideration payment. As per the accounting standards, the payment may be any medium like cash consideration or monetary assets. It loopholes automatically turn illegal money into legal money. This accountingstandard shall be excluded from the purview of valuation of intangibles. This acquisitionprice may exclude the import duties, non-refundable consumption taxes, trade discounts, rebates, any cost incurred for advertisement and promotional activities, cost of staff trainingto handle that intangible property, and initial losses before creation of intangible assets. Thereare so many costs that were excluded from the purview cost of approach. But a company may show less cost on balance sheet and sale the same intangible property at lowest price. Itis one of the biggest issues to escape tax liability. In most developed countries are not follow this cost method.[10] The practical difficulty faced in the course of different in expenditure and after completion value. Advertisement is an essential criterion to be added to the valuation. But, it is out of purview at valuation of intangibles. This method is not suitable for the future cost, and is applied to the preceding cost made by the company.

Act of Acquisition in Business combination

The acquisition of intangible assets may occur in the business combination. The fairmarket value of intangible asset ascertains from the date of acquisition and future economic benefits of the property. There are some uncertainty held at the time non-availability data on timing, and value of in flow. The intangible assets might be acquired in a combined one. Therecognizer can individualize the good will from intangible asset and value together. The major problems in business combination lead to identification original value of intangibles.

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[8] MICHAEL J.MARD, HITCHNER.R & HDEN.D, VALUATION FOR FINANCIAL REPORTING: FAIR VALUE, BUSINESS COMBINATIONS, INTANGIBLE ASSETS, GOODWILL, AND IMPAIRMENT ANALYSIS, INDIA, 94 (Wiley, 2010).

[9] Ministry of corporate affairs, Indian Accounting Standards 38, MINISTRY OF CORPORATE AFFAIRS, (March 21, 2019, 12.25 PM) https://www.mca.gov.in/Ministry/pdf/IndAS38_2019.pdf

[10] HENNING FISCHER, VALUATION OF SERVICE COMPANIES WITH INTANGIBEL ASSETS: THE CASE OF THE DEUTSCHE TELEKOM, INDIA, 67 (Grin Verlag,2015).

Research and expenditure expense are added to the cost of intangibles. In a taxation view, a taxpayer has a right to deduct some amount of expenses from total income. According to the Income Tax Act, 1961, an expense on scientific research is claimable as a deduction. This expenditure deduction limit is 150% of total expense. The expenses are deductable under the category of capital and revenue expenditure. As per section 35 (1)(i) clearly declaring the revenue expenditure. Capital expenditure dealt under section 35 (1)(iv) r/w section 35(2).[11] Due to that, multinational companies may easily deduct more expenses in the name of in- house scientific research and development. Mncs claim deductions from one side and fix the lowest price of intangible property. Finally, Mncs easily escape from tax liability. The acts ofMncs use the loopholes in law and continuously do the legal evasion of tax.

MARKET APPROACH

Market price comparison is one of the issues from beginning of price and valuation. Intangible properties are unique one. First and foremost default in comparison may beauthentication of data or codification of data. This market approach methods is similar to Comparable Uncontrolled Price methods (CUP Method). These methods are already failure methods and same declared by Organization of Economic and Social Development (OECD). The purpose adopts this method for valuation leads to unfair value. Comparison data may not be authenticated. Unless, it maintained by the Government or International organizations. Non-codified data may be manipulated at the hands of multinational companies or associated enterprises. Comparison will be a failure for following reasons:-

- Unauthenticated or non-codified data
- Data easily manipulated
- Data availability
- Data may not be applicable to current case flow.
- Methods of accounting may be different from country to country.

INCOME APPROACH

The income-based approach may not be suitable for finding the original value of intangible assets. These methods applied with following data needs such as, individuation, identification, ascertain the cash flow or any payment made as royalty fee to intangible asset. There are more number of risk will arise at the time analysis the capitalization of future cash flow. Income approach focused on presumption of monetary benefits of intangible assets. Thevalue of intangible assets ascertain from the current estimated profits or any other cost made by the intangible property owner. Income methods also include the methods followed under the cost method.[12] Especially, company or management made any expenses to maintain, and improve the intangible assets. Usually, income approach recognized for the legal agreements, non-competition agreements, and trademark.

Generally, multinational companies are used to show zero income and relax their tax liability.

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[11] Income Tax Management, Scientific Research Deduction, (June 8,2018). https://library.stritch.edu/getmedia/68645fbb-f965-4ea0-a63d-14672a6c5fb7/APAStyleGuide6

[12] Ipleader, Valuation of intangibles, (June 22,2021), https://blog.ipleaders.in/valuation-of-intangibles/

In taxpayer view, Mncs interested to express less income in valuation of intangible assets. The act will cause revenue losses to concern the government. The valuation shall be done by the government or any authorized authority. Otherwise, Mncs manipulate the valuation procedure and undervalue the intangible assets. Finally, Mncs will get less burden of tax and escape from the less burden.

Relief from royalty payment: the value of intangible properties can be ascertained from any cost incurred or royalty payment or any payment charged from the customer, and less the value of assets.[13]

Greenfield method: Greenfield methods used to assess the value of intangible assets with specific reference to the franchise agreements valuation. Most methods are not suitable for the valuation of intangible assets such as, patent, trademark, copyright, etc., Greenfieldmethod failure by the valuation methods. According to the Greenfield method, tangible and intangible are valued together. It causes confusion on finding the original valuation of intangibles.[14]

Multi-period excess earnings method: this method may be used in the comparative way. For example: there are two intangible assets taken for valuation such as, consumer lists, and Patent right. Consumer rights shall be valued under the multi-period excess earning method and patents valued under the other approach. The formula for these valuation methods as, current turnover value shall be deducted from other corresponding expenditures.[15] Surplus cash flows will be taken in to consideration for valuation. According to the principle of natural justice, no one judges their own case. But, this valuation method clearly designates that, valuation done by owner of intangibles. Therefore, the locker key should not be given to the thief. Definitely, valuable things may be stolen by a thief. The valuation shall be done at the hands of the common man or any authorized government agencies.

CONCLUSIONS AND SUGGESTIONS

Intangible asset valuations have become contemporary issues around the world. This issue may be rectified by proper valuation approaches, and same methods uniformly applied everywhere. Usually, intangible valuation issues held at the time of international transactions.There are some price fixation methods discussed under the Income Tax Act, 1961. The OECD declared that, methods used under domestic law is not useful to ascertain the price of intangible property. Countries shall update the hard-to-value-intangible approach to fix the actual price. India is not followed those recommendations as of now. Indian accounting standards methods are not suitable to value the intangibles, and same tested from the above- mentioned paragraphs. The research concluded with appropriate suggestions to remove these loopholes.

- The royalty data shall be codified by the concerned government organizations.
- The government or other statutory authorities may frame a valuation manual withoutany lacuna.
- Indian accounting standards shall be changed standards of valuation methods

[13] Antonella Pucha, The intangible Valuation renaissance: Five methods, CFAINSTIUTE. BLOG (Sep. 28,2023, 9.32 A.M), https://blogs.cfainstitute.org/investor/2019/01/11/a-renaissance-in-intangible-valuation-five-methods/

[14] Ministry of corporate affairs, Indian Accounting Standards 38, MINISTRY OF CORPORATE AFFAIRS, (March 21, 2019, 12.25 PM) https://www.mca.gov.in/Ministry/pdf/IndAS38_2019.pdf

[15] Vidiya Sunderam, Intellectual Property : Concepts, LEGAL SERVICE INDIA (Jan. 17,2022, 10.22 A.M),

according to the time period.

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12. The chamber of tax consultans. (2022) transfer pricing- a compendium, india, 182 (11th ed.) taxmann's.
13. Vidiya sunderam.(2022) intellectual property : concepts. legal service india. https://www.legalserviceindia.com/articles/ipvalu.html