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Decision of the Assessment Review Committee

In the matter of:

Avago Technologies Trading Limited
(“Appellant” or “the Company”)

v/s

The Director General
Mauritius Revenue Authority
(“Respondent” or “MRA”)

Key Issue: *Whether the royalty fees paid by Avago Technologies Trading Ltd (ATTL) to its related entity, GEN IP (Singapore), were excessive, not at arm's length, and constituted a tax avoidance arrangement?*

Executive Summary

On 4 July 2024, in the matter of Avago Technologies Trading Limited (ATTL) v/s Director General, MRA, the Assessment Review Committee (ARC) ruled in favour of the Mauritius Revenue Authority (MRA) and determined that the royalty fees paid by the Mauritian company were excessive and not at arm's length, constituting a tax avoidance arrangement. The ARC also supported the MRA's position that the royalty fees claimed as deductions by ATTL were inflated to shift profits from Mauritius (where ATTL would have suffered an effective tax rate of 3% on its profits) to Singapore, where the royalty fees were exempt.

Detailed Discussions

The present case concerns years of assessment 2011 to 2015, claiming a total tax payable of USD 107,933,164 plus penalties and interest.

ATTL (the Appellant) is a company incorporated in Mauritius and the holder of a Category 1 Global Business Licence (now replaced by the Global Business Licence). ATTL is part of the Avago Group operating in the semiconductor industry and is a wholly owned subsidiary of Gen IP (Singapore). ATTL acts as the Principal Manufacturer of Avago products and sells finished products to related parties. To manufacture the semiconductors which ATTL sells to its related parties, it licences the Avago IP from Gen IP and, consequently, pays royalty fees to Gen IP to use the Avago IP and make it available to Contract Manufacturers (CMs): ATTL derives profits from its activities equivalent to 7% of its operating assets and the remainder is paid as royalty fees to Gen IP.

For the years under contention, ATTL claimed full deduction for the royalty fees paid to Gen IP. The MRA did not agree with the deduction claimed by ATTL and allowed a royalty expense deduction of only 5% of net sales under section 18 of the Income Tax Act 1995 (ITA), which deals with Expenditure incurred in the production of Income. The MRA also considered that the main/sole objective of the arrangement was to shift the bulk of the profits of the Company to Gen IP in Singapore where these profits are exempt from income tax and deemed that, since both parties to the transaction are related, the whole arrangement was designed for the sole and dominant purpose of avoiding tax liability in Mauritius. The intercompany agreement was considered to be an arrangement or scheme caught under the provisions of section 90 of the ITA, that is the anti-avoidance provisions of the ITA.

The additional main arguments for the MRA were also as follows:

1. The structure and frequency of the royalty payments were not consistent with industry practices. The MRA emphasised that royalty payments in such high proportions (96-98% of operating profits) are unprecedented in the semiconductor industry, indicating that the primary purpose was profit shifting.
2. ATTL used the Transactional Net Margin Method (TNMM) to justify the royalty payments, but the MRA preferred the Comparable Uncontrolled Price (CUP) method, arguing that TNMM was not appropriate for directly valuing intangibles. The MRA contended that the CUP method would have provided a more accurate reflection of what independent enterprises would have agreed upon in similar circumstances.
3. The MRA considered that the payment of the royalty fees was independent of actual IP supplied by Gen IP and was, in fact, dependent entirely on residual profit remaining after attributing a profit to ATTL.

On the other hand, the main arguments of ATTL were as follows:

1. ATTL, with only 2 employees with no experience in the industry, could not receive USD 2.7 billion in profits when the group as a whole with thousands of employees and years of experience generated only USD 2.6 billion in profits. ATTL emphasised the limited functions and risks assumed within Mauritius, asserting that the royalty expenses were necessary and justified.
2. When ATTL filed its income tax returns for the relevant years, it also filed reports from PWC which analysed and tested the arm's length nature of royalty fees paid by ATTL and the net income of ATTL. The reports relied on the OECD's Transfer Pricing (TP) Guidelines applicable at the time. The PWC analysis confirmed that during the relevant years, ATTL received an arm's length net income and that the royalty fees paid by ATTL to IP holders was at arm's length. It is to be noted that the case of ATTL relied mostly on the PWC report.
3. ATTL incurred the royalty fees exclusively for the production of gross income so that the provisions of section 18 of the ITA had been met. ATTL argued that the royalty fees were a legitimate business expense necessary for utilising the valuable IP held by Gen IP.

Ruling of the ARC:

The ARC agreed with the MRA and ruled that the royalty fees paid by ATTL were indeed excessive and constituted a tax avoidance scheme. The following points summarise the ARC's ruling:

- The ARC determined that the MRA's adjustments and rationale for disallowing the full deduction of royalty fees were based on a reasonable interpretation of the ITA. The ARC found that the methodology employed by the MRA in limiting the royalty deduction to 5% of net sales was appropriate given the circumstances. ATTL was for all intents and purposes the principal manufacturer of Avago products, and it cannot be denied that manufacturing was also an essential part in the production of Avago products. The ARC noted that ATTL's role was critical to the manufacturing process and, therefore, its profit attribution should reflect this importance: ATTL paid CMs to create value, which is why the huge profits accrued to ATTL (before royalty).

- The ARC upheld the MRA's view that the arrangement was primarily for tax avoidance and maintained the adjusted assessments for the relevant years. The ARC concurred with the MRA's assessment that the main objective of the royalty payments was to shift profits to Gen IP in Singapore, thereby minimising the tax burden in Mauritius.

- The ARC emphasised the fact that royalty payable by one party must at least be ascertainable by the Revenue Authority through a basis of calculating the royalty fees. Even where the taxpayer can provide a Transfer Pricing Report to justify the amount of royalty fees, such a report must align with reality and be verifiable.

- Importantly, the ARC agreed that the MRA had no requirement to consider the OECD TP Guidelines or information required under these guidelines to decide the royalty amount that would be allowed under section 18 of the ITA, considering that Mauritius has not implemented TP legislations. The ARC went further and added that the fact that the Appellant had prepared a TP report in accordance with OECD TP guidelines does not mean that the TP report was accurate and had to be accepted.

- The ARC emphasised that the TNMM method could only be accurate if all payments to related parties had been at arm's length and all related parties had been paid for their services to ATTL. The ARC concluded that the TNMM employed by ATTL was flawed as it did not account for the true value of services and IP provided by Gen IP.

Concluding remarks

The present case marks a significant and long-awaited ruling in Mauritius. Although it primarily addresses the deductibility of expenses incurred by a company, it also brings transfer pricing concepts to the forefront in a jurisdiction currently lacking specific transfer pricing legislation. This ruling has significant implications for multinational enterprises operating in Mauritius, highlighting the importance of adhering to the arm's length principle and ensuring that intercompany transactions reflect genuine economic activities and risks.

The case underscores that a TP report or benchmarking study alone is insufficient. Taxpayers must provide robust commercial reasoning for the prices applied in related party transactions. This ruling makes it clear that merely presenting a transfer pricing report or benchmarking study to justify intercompany pricing is inadequate. These documents must be substantiated by strong commercial justifications that accurately reflect the economic activities and risks borne by the entities involved.

Additionally, the case highlighted the need for detailed and comparable independent transactions to support the claimed pricing. The absence of such evidence in ATTL's case pointed to the necessity of a more thorough analysis and justification for the royalties paid to Gen IP.

We also understand that policymakers have begun consultations on formal transfer pricing regulations, and we may expect these regulations to be implemented in the coming year or two. This anticipated regulatory framework will offer clearer guidelines and a more structured approach to transfer pricing, providing much-needed clarity and direction for multinational enterprises operating in Mauritius.

We do not know yet if the appellant will appeal to the Supreme Court, and it remains to be seen how the matter unfolds.

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