Definition of Royalties & Allocation Rules under DTAA's

Dated: 15.09.2024

Nalsar University of Law,Hyderabad

M.A (International Taxation)

Presented by CA.Shweta Ajmera

(FCA, LL.B(Hons),DISA(ICAI),M.Com, B.Com(Taxation)

Course on International tax, CCCAB(ICAI),FAFD(ICAI)

Email id: ajmerashwetaca@gmail.com

Broadly understanding concept of Royalty

- No PE in India- Taxability as per Gross basis
- PE in India- Taxability as per Net basis
- Tax Rate 115A: 20%
- Article 12 or 13 of DTAA
- Section 90(2)- Beneficial clause
- Section 90(4)-TRC
- Section 206AA

Broad Scheme of Taxation

- Total Income
- Source or Residence Rule
- Section 4- Charging section
- Section 5- Income received or deemed to be received in India, accrues or arises or deemed to accrue or arise in India
- Section 9-Income which are deemed to accrue or arise in India

Meaning of Royalty

- Royalty refers to a **contractual payment** by a person for the use of assets belonging to another person. The payment includes royalty for the use of Intangible assets such as **copyrights, trademarks or franchise model agreements**. Royalty is also paid for the use of natural resources such as mining, leases. Royalty agreements generally give limited rights to use such assets or resources.
- There are two parties to a Royalty agreement:
- “Licensor”- The party granting right to use an asset or resources.
- “Licensee”- The party accepting the right to use & pays for the right in the license.

Royalty Agreement

- Royalty agreement specifies the terms and conditions of grant of right to use under the agreement.
- The agreement also mentions the consideration for the right to use & the duration.
- From a tax perspective, royalty agreements should be on Arms Length basis.
- The taxation however depends on the laws of each country

Encyclopedia Britannica 1972 Edition defines Royalty as:

- It says Royalty means " The payment made to the owners of certain types of rights by those who are permitted by the owners to exercise those rights. The rights concerned are literary, musical & artistic copyright, rights in inventions & designs & rights in mineral deposits including oil & natural gas. As to inventions, a royalty may be said to be compensation paid under a license granted by the owner of the patent (the licensor) to another person (the licensee) who wished to make use of the invention, or the subject of the patent. The patent remains the property of the licensor.

<u>Encyclopedia Britannica 1972 Edition defines Royalty as:</u>

- A license may be :
- exclusive, in which case the patent owner precludes himself from granting licenses to third parties or
- non-exclusive, in which case the patent owner may grant licenses to as many persons as he wishes.

Wharton’s Law Lexicon defines Royalty as:

- “ Payment to a patentee by agreement on every article made according to the patent or to an author by a publisher on every copy of the book sold, or to the owner of mineral for right of working the same on every ton or other weight raised”.

Law Lexicon by Ramanathan Aiyer

- “Royalty would mean-

(a) percentages or dues payable to land owners for mining rights

(b) Sum paid for the use of patent

(c) Percentages paid by an author, by a publisher on the sale of a book

Wikipedia defines Royalty as:

- Royalties(sometimes running royalties or private sector taxes) are wage based payments made by one party (the licensee) & another (the licensor) for on going use of the asset, sometimes an intellectual property. Royalties are typically agreed upon as a percentage of gross or net revenues derived from the use of an asset or a fixed price per unit sold of an item as such, but there are also other modes and metrics of compensation.

Black Law Dictionary 11th Edition defines Royalty as

- In respect of intellectual property, royalty is defined as “ a payment –in addition to or in place of an upfront payment- made to an author or inventor for each copy of a work or article sold under a copyright or patent.
- Royalties are often paid per item made, used or sold as per time elapsed.

Section 9 of The Income Tax Act, 1961

- Section 9(1)(vi): Royalty Income
- The following Income shall be deemed to accrue or arise in India: Income by way of royalty payable by—
- (a) the Government ;
- (b) or a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ;
- (c) or a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India :

Exception in sub-clause(b) of section (1)(vi) - Source of Income outside India

- **Aktiengesellschaft Kuhnle Kopp & Kausch W. Germany v. BHEL** (262 ITR 513)(Madras) The High Court stated that exclusion shall be applied in case of export sales and held that as far as export sales is concerned, that amount is also exempt u/s 9(1)9(vi) of the Act. Though a resident in india paid the royalty, it cannot be said that it was deemed to have accrued or arisen in India as the royalty was paid out of export sales and hence the source of the royalty is the sales outside India. Since the source of the royalty is from the source situated outside India, the royalty paid on export sales is not taxable
- **CIT v. Havells India Ltd**. (352 ITR 376)(Delhi) The High Court held that the real question is whether the export sales proceeds received from goods manufacture and exported from India constitute a source inside or outside India. To decide the same we have to take pragmatic and a practical view and not approach the question from a theoretical perspective. We are making a distinction between the source of the income and the source of receipt of the monies. In order to fall within the second exception provided in section 9(1)(vii)(b) [similar to section 9(1)(vi)(b)] of the Act, the source of the income and not the receipt should be situated outside India.

<u>Exception in sub-clause(b) of section (1)(vi)</u>

- **Source of Income outside India:**
- **Lufthansa Cargo India Pvt Ltd. V. DCIT (92 TTJ 837) (Delhi ITAT**) The payments for repair of aircrafts abroad which were acquired for operating on international routes only was held to fall under the exclusion clause of 9(1)(vii)(b)[similar to 9(1)(vi)(b)]
- **Titan Industries Ltd. V. ITO (11 SOT 206)(Bangalore-ITAT)** The ITAT held that the assessee company which was engaged in manufacture and sale of watches under the patent name 'TITAN' having an associate company incorporated in Singapore for promoting sales of watches in APAC region and got its patent registered in Hong Kong could claim the exception clause u/s 9(1)(vii)(b) for the fees paid to register the patent

Section 9 of The Income Tax Act, 1961

- Section 9(1)(vi): Royalty Income Royalty Income shall be deemed to accrue or arise in India if:

Payer	Conditions
Indian Government	No conditions
Resident in India	All cases, Except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India
Non Resident in India	Only where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India

Explanation 2 to Section 9(1)(vi)

- Royalty means consideration (Including a lump-sum consideration other than consideration chargeable under the head “Capital Gains”) for:
- (i) The transfer of all or any rights (including granting of the licence) in respect of a ------
- patent,
- invention,
- model,
- design,
- secret formula or
- process or trade mark or
- similar property.

(ii) The imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property ;

(iii) The use of any patent, invention, model, design, secret formula or process or trade mark or similar property ;

Explanation 2 to Section 9(1)(vi)

- (iv) The imparting of any information concerning
- -technical,
- -industrial,
- -commercial or scientific
- -knowledge, experience or skill ;
- (iva) The use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

Explanation 2 to Section 9(1)(vi)

- (v) The transfer of all or any rights (including the granting of a licence) in respect of any
- - copyright,
- - literary,
- - artistic or
- - scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting ,
- ~~but not including consideration for the sale, distribution or exhibition of cinematographic films;~~ or
- (vi) The rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Explanation 2 to Section 9(1)(vi)

- Explanation 3 to Section 9(1)(vi) Computer Software means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data.
- Explanation 4 to Section 9(1)(vi) It is clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Explanation 5 to Section 9(1)(vi)

- It is clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—
- (a) the possession or control of such right, property or information is with the payer;
- (b) such right, property or information is used directly by the payer;
- (c) the location of such right, property or information is in India.

Explanation 6 to Section 9(1)(vi)

- It is clarified that the expression "process" includes and shall be deemed to have always included transmission by
- - satellite (including up-linking, amplification, conversion for down-linking of any signal),
- - - - cable,
- optic fibre or
- by any other similar technology,
- whether or not such process is secret;

Definition of know-how

- As per ANBPPI know-how is
- all the undivulged technical information,
- whether capable of being patented or not,
- that is necessary for the industrial reproduction of a product or process,
- directly and under the same conditions;
- inasmuch as it is derived from experience, know-how represents
- what a manufacturer cannot know from
- mere examination of the product and mere knowledge of the progress of technique.

Referral Fee – Whether Royalty

- A referral fee did not amount to royalty within the meaning of explanation 2 to Section 9(1)(vi) as there was no information imparted regarding commercial knowledge or experience, providing “bald commercial information was not royalty”

“Use” or “Right to Use”

- The expression “use” is not defined in the Act as well as Article 12 of the Model convention and includes leasing, letting or licensing.
- The oxford English reference dictionary defines “use” as meaning “exploit for one’s own ends, employ for some purpose; apply to one’s own purpose; the act so employing, using, or putting into service’.
- A one-time “use” is sufficient to constitute royalties and repetitive “use” is not necessary.
- The word “right: denotes “entitlement”. The expression “right to use” means “ a grant, whether exercised or not” as opposed to “use” which signifies “a grant as exercised”.

<u>‘USE’</u>

- It was held that the word ‘use’ in relation to equipment occurring in clause (iva) of explanation 2 to section 9(1)(vi) is not to be understood in the broad sense of availing the benefit of an equipment. There must be some positive act of utilization, application or employment of equipment for the desired purpose. The customer must operate or control the equipment in some manner and exercise a certain degree of possession and control.

Royalty Provisions-Model Tax Conventions-Article 12(1)- Resident Taxation Clause

OECD MODEL	US MODEL	UN MODEL
1.Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.	1.Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other Contracting State.	1.Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation

Royalty Provisions-Model Tax Conventions Article 12(2)- Royalty Definition Clause

OECD Model	US Model	UN Model
2.The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.	4.The term "royalty" as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including cinematographic films); any patent, trademark, design or model, plan, secret formula or process; or for information concerning industrial, commercial or scientific experience.	3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

Analysis

- The UN model covers the phrase “for the use of, or the right to use, industrial, commercial or scientific equipment “, which is in line with section 9(1)(vi) of the Income Tax Act.
- “The Revision of the Model Convention” adopted by the Council of the OECD on 23 July 1992 removed the above phrase.
- These words still form a part of the UN Model Tax Convention, 2017.
- Hence, as per the UN model such payments constitute to be royalty and as per the OECD model they will fall in the Article 7 (Business Profits)

Analysis

- However, under the Article 12 to apply, in case of an equipment the following factors are to be tested:
- 1. Who is in physical possession and controls the property/equipment
- 2. Who has significant economic or possessory interest in the property
- 3. Who bears the risk of substantially diminished receipts or substantially increased expenditure if there is non performance under the contract
- 4. Who uses the property/equipment concurrently to provide significant services to entities unrelated to the service recipient
- 5. Total payment for the service does not substantially exceed the rental value of the computer equipment for the contact period

Best Regards:

CA.Shweta Ajmera

(FCA, LL.B(Hons),DISA(ICAI),M.Com, B.Com(Taxation)

Course of International tax, CCCAB(ICAI),FAFD(ICAI)

Email id: ajmerashwetaca@gmail.com