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Royalties:- Definition under ITA and Arm's Length Rule

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General Concept of Royalty

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Royalty: General Concept

Usage-based payments made by one party (the “licensee”) to another (the “licensor”) for ongoing use of an asset (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

Intangible - License Agreement; and Know-how – Technology Transfer Agreement

Generally, made for usage of intellectual property such as patents, inventions, models, secret formulae, processes, designs, trademarks, service marks, trade names, brand names, franchises, licenses, commercial

industrial know-how, copyrights, cultural activities, films or television rights, literary, artistic or scientific works, computer software, exclusivity rights, etc.

Royalty essentially signifies payment for ‘user right’.

Definition under the OECD Model and Income-tax Act, 1961

Royalty: Definition under OECD Model

Payment of any kind received as a consideration for use or right to use any copyright of literary, artistic and scientific work, including:

- Cinematographic films
- Patents
- Trademark
- Design
- Model or Plan
- Secret Formula or Process
- Information concerning industrial, commercial and scientific experience

Royalty: Definition under the Income-tax Act, 1961

Section 9(1): Following incomes shall be deemed to accrue or arise in India:-

…

(*vi*) income by way of royalty payable by—

(*a*) the Government ; or

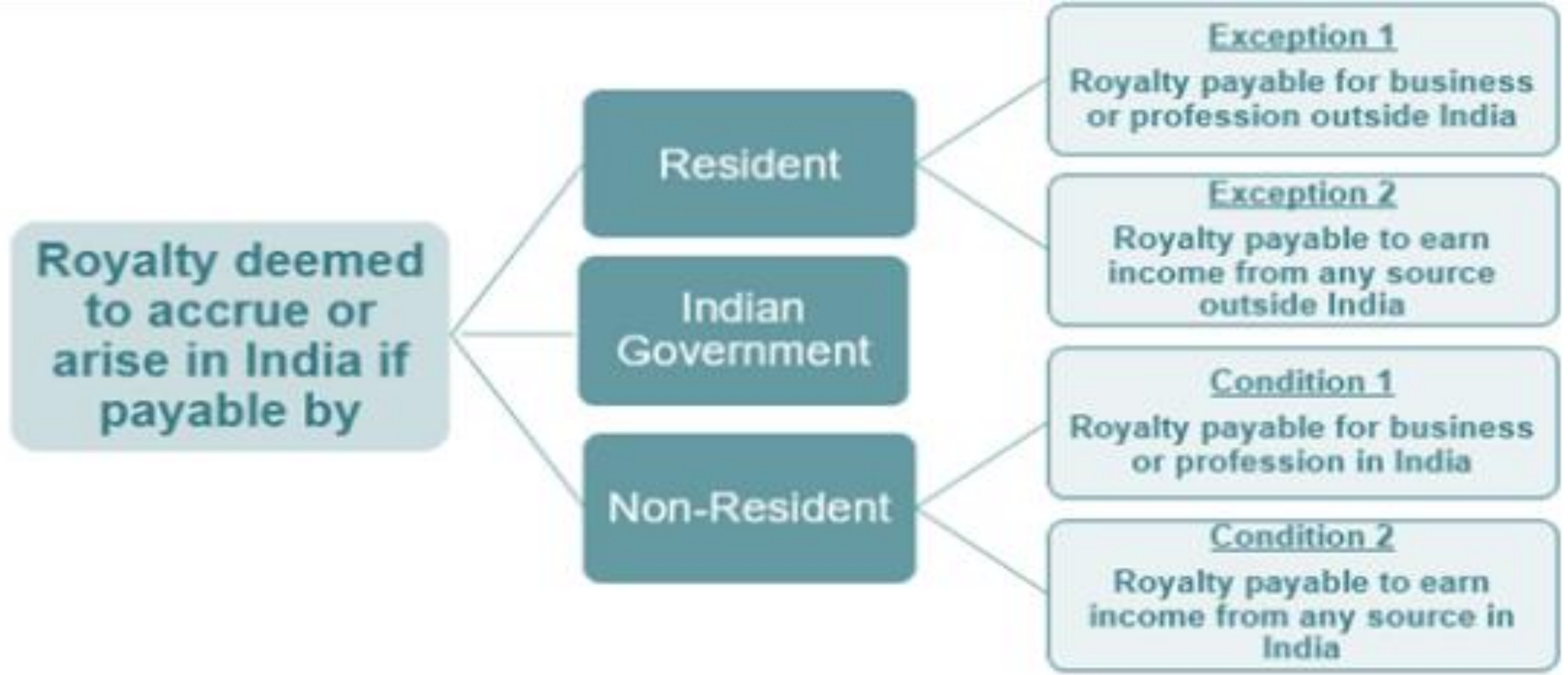
(*b*) a person who is a **resident**, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or

(*c*) 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:

Royalty under Section 9

Royalty payable to the Non-Resident, could be from the following payors:

1. Royalty payable by Indian Government
2. Royalty payable by Resident to Non-Resident
3. Royalty payable by one Non-Resident to another Non-Resident



Explanation 2 to Section 9(1)(vi)

Royalty means consideration…..for:

i. the <u>transfer of all or any rights</u> (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
ii. the <u>imparting of any information concerning the working of or the use of,</u> a patent, invention, model, design, secret formula or process or trademark or similar property;
iii. the <u>use</u> of any patent, invention, model, design, secret formula or process or <u>trademark</u> or similar property;
iv. the <u>imparting of any information</u> concerning technical, industrial, commercial or scientific knowledge, experience or skill;

iva. the <u>use or right to use</u> any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

v. the <u>transfer of all or any rights</u> (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 <u>in connection with</u> the activities referred to in the above-mentioned points

Case Study I - Facts

Parent Company in France

Developed IP by using an in-house R&D Team

Online payment

IP Licensing: brand name and trademark

Manufacturing facility in India

Utilizes the IP from the Parent to sell the manufactured product in India

-What will be the taxability of such a transaction as per the Income Tax Act and articles of DTAA?

-Whether any TDS implication u/s 195 arises on payment by the Indian Manufacturing facility to Zoom?

Case Study – India- France Treaty Text

1. Royalties, fees for technical services and payments for the use of equipment arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such royalties, fees and payments may also be taxed in the Contracting State, in which they arise and according to the laws of that Contracting State, but if the recipient is the beneficial owner of these categories of income, the tax so charged shall not exceed 10 per cent of the gross amount of such royalties, fees and payments.

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, **trade mark**, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

The payments are covered under the Income-tax Act and India-France Treaty as 'royalty'. India will have the right to tax the payment but India's right to tax will be capped at the rate of 10%.

Royalty v Business Income

- **Amount received by the taxpayer for the licence of its product, which was embedded software, was not royalty rather, it was business income**

(CIT (International Taxation)-1 v. Bently Nevada LLC)

- **Sum received for permitting the use of certain marks and intellectual property belonging to the taxpayer (a UK based company) for privilege of hosting and staging Formula F1 championship race which had been strictly confined and limited to use only for the promotion of the event and for no other purpose held not to be 'royalty' but 'business income'**

(Formula One World Championship Ltd. v. CIT)

Judicial Trends

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Engineering Analysis Centre of Excellence Pvt Ltd v. CIT (SC)

Facts

- EAC, an Indian resident, imported shrink-wrapped computer software from the USA (AY 2001-02 and 2002-03)
- The department treated the consideration as Royalty, as what was being transferred in this transaction was copyright. Thus, there was an obligation on the Indian resident to withhold tax at the time of payment

Questions before the Court:

Whether payments made by Indian residents for the purchase of computer software from foreign software suppliers are in nature of 'Royalty' as defined under explanation 2 to Section 9(1)(vi) of the Act and DTAA

Whether withholding obligation under Section 195 of the Act is applicable

Engineering Analysis Centre of Excellence Pvt Ltd v. CIT (SC)

- **Finance Act, 2012, inserted Explanation 4, which had a retrospective effect from 01.04.1976:**

  "Explanation 4.—For the removal of doubts, it is hereby 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."

- **There is parting of a right or interest in copyright by the distributors of copyright software license or sell such computer software to end-users and, as a consequence, would be hit by Section 14(b)(ii) of the Copyright Act.**
- **Supreme Court demarcated the license agreements into the following categories:-**

Category I - Indian end-user	Category II - Indian distributor	Category III - Resale by foreign vendor to Indian distributor or end-users	Category IV - Software embedded in hardware

Engineering Analysis Centre of Excellence Pvt Ltd v. CIT (SC)

Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts

Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied. A purchaser of DVD becomes owner of the book, not the rights therein, which remain with the owner

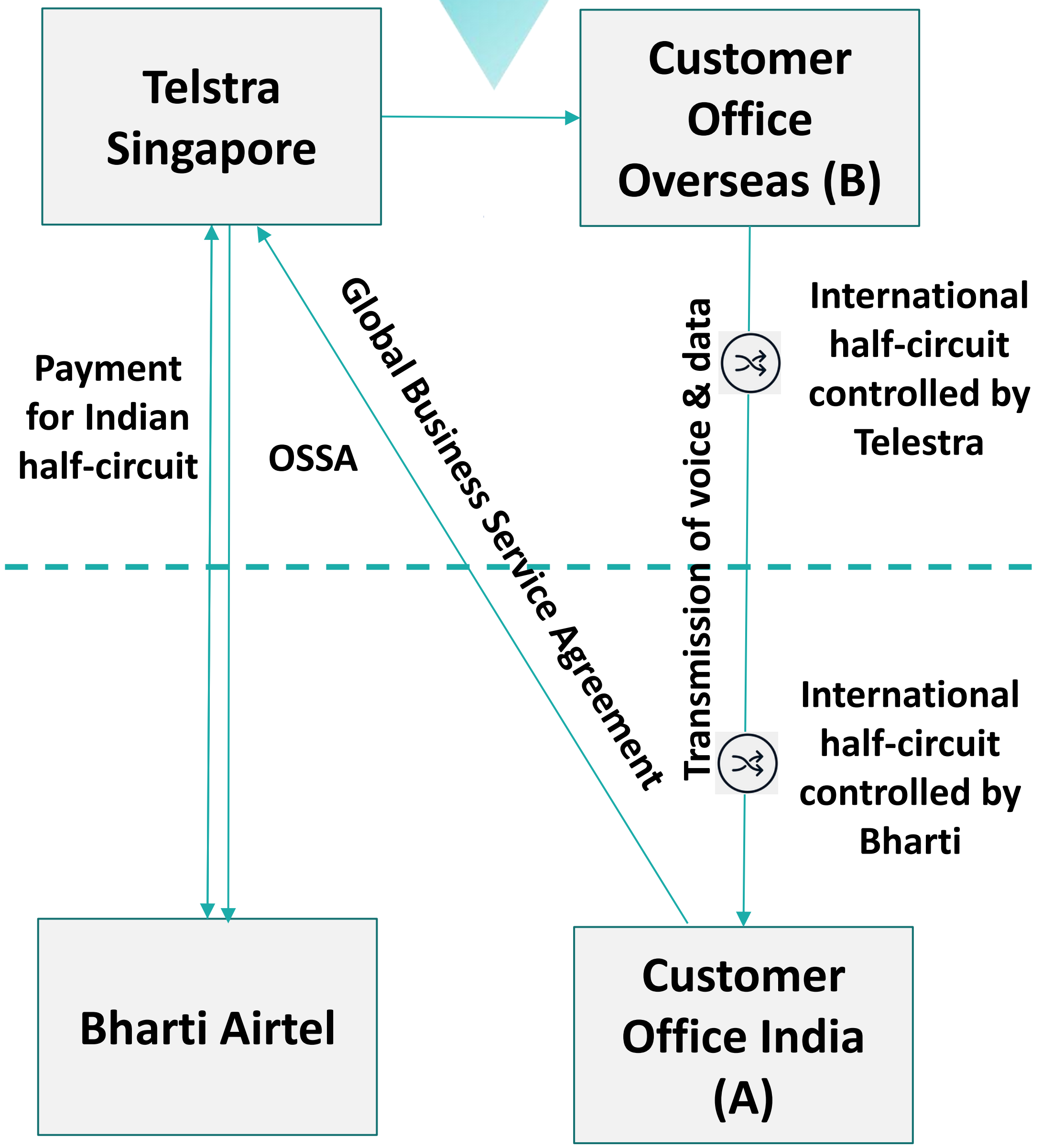
Parting with copyright entails parting with the right to do any of the acts mentioned in section 14 of the Copyright Act

Licence from a copyright owner, conferring no proprietary interest on the licensee, does not entail parting with any copyright, and is different from a licence which grants the licensee an interest in the rights under Section 14 of the Copyright Act

The agreements do not create any interest or right in such distributors/end-users, which would amount to the use of or right to use any copyright. Since provisions of DTAA are more beneficial, definition thereunder will be taken, which clearly does not construe such interest as royalty.

CIT v. Telstra Singapore Pte. Ltd (Del HC)

- The taxpayer is a Singapore-based company that entered into a One Stop Shopping Service Agreement (OSSA) with Bharti Airtel for reciprocal services being provided by the concerned taxpayer and Bharti Airtel dependent upon the location of their customers.
- The entire infrastructure and equipment with which the taxpayer provided transmission/bandwidth services are situated outside India, and it never rents out that equipment.
- The Department sought to tax the amount received by the taxpayer from Indian customers for the provision of bandwidth services outside India being liable to be construed as constituting equipment/process royalty taxable under Explanation 6 to Section 9(1)(vi) of the Act read along with Article 12(3) of the DTAA.



CIT v. Telstra Singapore Pte. Ltd (Del HC)

Section 9 amendments cannot be read as having subsumed, eclipsed or overridden the provisions of the DTAA. Further, the definition under the domestic law cannot be relied on under Article 3(2) if the term is defined the Treaty itself.

In order to fall within the ambit of the 'royalty' under the Treaty, a right must be given to make use of the patent, trademark process or equipment. The key element would be effective control or dominion having been conferred upon an individual or entity for consideration (customers and others availing the services).

<u>The use of service equipment or processes remains within and in the control of the provider and cannot attract process or equipment royalty provisions. There is no transfer or grant of dominion or control over the equipment so mere use or deployment of equipment or during provision of a service would not attract Art 12.</u>

The OSS Agreement stipulated that Telstra and Bharti sought to provide international roaming services to their respective customers in a coordinated manner.

Roaming agreements have been specifically evaluated in both the OECD as well as the UN Commentaries and which have unequivocally observed that the royalty provisions are not attracted to such agreements.

Google India (P) Ltd v. JDIT (Bang Trib.)

Facts

- Google Ireland Limited (GIL) operated its "Google AdWords Program‟, under which ads were displayed on Google's search engine.
- Distribution Agreement – GIL appointed its Indian subsidiary as a non-exclusive distributor of AdWords programme to advertisers in India.
- Tax authorities characterized the distribution fee as 'royalty' since the payment was for use of or right to use various IP rights in the AdWords program and use of or right to use industrial, commercial or scientific equipment.

Issue

- Whether the Distribution fee can be characterized as Royalty.

Tax Tribunal Decision

- None of the rights, as per the Copyright Act, 1957, have been transferred by GIL to GIPL. Followed *Engineering Analysis Centre* to observe that mere use of or right to use a computer program without any transfer of underlying copyright- no royalty.
- The Technical Advisory Group ('TAG') - set up by the OECD - analyzed transactions relating to online advertisement and recommended the taxability under Article 7 (Business Profits).
- Unless such non-resident has a PE in India, no portion of receipts can be brought to tax in India.
- Held that the introduction of EL addresses such instances. Section 164(i) of the Finance Act, 2016 provides that "specified service" means an online advertisement. Thus, covered under EL.

Godaddy.com LLC v. ACIT (Del HC)

FACTS:

- **Taxpayer was a US-based company and was an accredited registrar for the Internet Corporation for Assigned Names and Numbers**
- **It provided services such as domain name registration, website design, and web hosting. It charged a fee from its customers for facilitating domain name registration, which was shared, three ways.**
- **While a part of the fee received from the customers was kept by the taxpayer, a portion of the fee was shared with ICANN and the registry.**
- **The domain name's owner was the customer who sought domain name registration, who could, at his option, dissolve his engagement with the taxpayer and move to another registrar.**
- **The department sought to tax the payments received by the taxpayer for providing domain registration services as right to use or the use of servers maintained in the country.**

ISSUE:

Whether the payment made to taxpayer qualify as ‘royalty’ and thus, taxable in India

Godaddy.com LLC v. ACIT (Del HC)

The lower authorities had equated a domain name with a trademark and hence concluded that the consideration received by the taxpayer was in the nature of royalty since it involved the right to use or use of a trademark

The taxpayer is not engaged in licensing domain names; <u>it simply assists customers/registrants in obtaining registration of domain names</u>

With the domain name's registration, a unique internet protocol address (IP address) is created in favour of the customer

<u>The database concerning domain names and IP addresses is maintained in the servers owned by the taxpayer</u>

<u>Unless the taxpayer is receiving fee for transferring rights to use its domain name i.e., GoDaddy.com, to a third person, royalty provisions will not be attracted</u>

ACIT v. Creative Infocity Ltd (Guj HC)

FACTS:

- **Taxpayer was assigned with the task of developing IT Park in Gujarat, for which entered into an agreement with Naimisha (US company)for the supply of design and drawings of the project to meet with international standards.**
- **Thus, the Taxpayer made payments to a US company for providing architectural and structural engineering designs and drawing services.**
- **The department sought to tax the payments as royalty and claimed requirement of withholding tax on the taxpayer.**

ISSUE:

Whether the payment made by taxpayer towards supply of designs and drawings to non-resident architect qualify as ‘royalty’

- **The transaction between the taxpayer and M/s Naimisha for the supply of design and drawings was an outright purchase. The non-resident parted with ownership on payment, thus, cannot construed as ‘royalty’ for mere use of those designs and drawings.**

Arm’s Length Rule for Royalty Payments

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Arm's length Rule for Royalty [Article 12(4) of OECD MTC]

- **Para 4 of Article 12**

Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Arm's length Rule for Royalty [Article 12(4) of OECD MTC]

Comes into operation if the amount of the royalties paid exceeds the amount which would have been agreed upon between independent parties

The excess payment is by virtue of special relationship between the parties (legal or personal)

Royalty provisions will apply only to royalty payment arm's length standard

The excess payment will be taxed as per the law of contracting states

If the two contracting states have different characterization of excess payment, then MAP provisions will apply

PCIT v. Samsung India Electronics (P) Ltd (Del HC)

FACTS:

- Taxpayer is engaged in manufacturing and sale of mobile handsets in India as well as overseas and has entered into a Technology License Agreement with its parent company located in Korea.
- Under the agreements, the taxpayer is obligated to pay for technical assistance and royalties to its parent company on receipt of technical know-how and expertise.
- The Department sought to characterise the taxpayer as a contract manufacturer as opposed to licensed manufacturer and the royalty paid as a percentage of sales to AEs' was not at arm's length since it would amount to collection of royalties on sales "to itself".

ISSUE:

Whether the payment made by taxpayer to its parent company as ‘royalty’ is at arm’s length

PCIT v. Samsung India Electronics (P) Ltd (Del HC)

Royalty payments were indelibly connected to the receipt of technical know-how and expertise from the parent company

Sales to those related parties were driven by open market conditions and were at par with the position that would have prevailed in case those sales had been made to unrelated parties

While the parent exercised close watch and oversight with respect to the quality of raw materials utilised and the production process, it neither controlled nor determined the quantity of production or the terms of sales.

The arrangement was not based on any assurance that goods manufactured by the taxpayer would be accepted or purchased by the parent, and there was no mandate to sell the goods to the parent or AEs

The transfer of technical know-how and licensing of technology was essential to enable the taxpayer to undertake its activities independently.

The Parent cannot be deprived of the right to obtain an arms' length return on the utilization of its patented or proprietary technology and know-how.

Thank you!

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