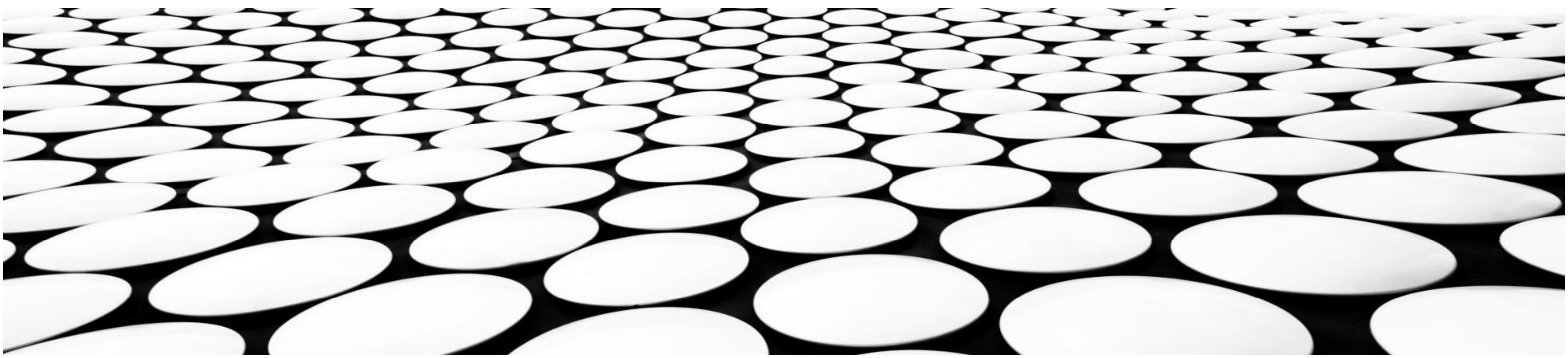
ROYALTY

CA BHAVYA BANSAL GOYAL



CONTENTS

- Arm’s length rule of royalty
- Definition u/s 9(1)(vi)

ROYALTY-ARM’S LENGTH RULE ARTICLE 12 (4)

ARTICLE 12

ROYALTIES

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.

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.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. 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.

ARTICLE 13

CAPITAL GAINS

ARTICLE 12

- The state of residence of the ‘beneficial owner’ of the royalty has the only taxing right (Article 12(1)); - *Velcro Canada Inc v The Queen* (2012 TCC 57)
- The definition of royalties. The OECD Model Treaty includes three main areas of intangible rights in relation to ‘payments of any kind received as consideration of, or the right to use’ such rights. These are: ‘any copyright of literary, artistic or scientific work including cinematograph films’; or ‘any patent, trade mark, design or model, plan, secret formula or process’; or ‘information concerning any industrial, commercial or scientific experience’ (Article 12(2));

ARTICLE 12

- the PE state may tax such royalties at the normal income/corporation tax rates; {Article 12(3)}
- Royalty payments arising under a special relationship which are excessive, taking into account ‘the use, right, or information’ for which they were paid, are denied the benefits of the royalties article {Article12(4)}

WHAT IS AN INTANGIBLE

- Ever wondered why an Ipad from Apple is more costlier than the tablet by Amazon, even though they are both manufactured in China or
- Why a Bentley is more expensive than a top end Volkswagen model even though they are owned by the same parent company.
- The simple reason is the brand value associated with it.
- In today's economy a company's value is not measured by its physical assets but is a combination of its physical and non physical assets, where the non-physical being the intangible assets forming a major part of the economic value.
- Intangibles are the key drivers of value in the innovation based economy today. Therefore, there pricing is a concern as they used by multinational enterprises (MNEs) to strip their profits and shift them to low taxed jurisdiction, which is major concern across the globe

THREE ATTRIBUTES OF AN INTANGIBLE ASSET:

1
- Identifiability

2
- Control (power to obtain benefits from the asset)

3
- Future Economic Benefits (such as revenues or reduced future costs)

DEFINITION OF INTANGIBLES

OECD Defines intangibles as:

"something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction"

Refer to 2017 OECD TPG, Para 6.6

- UN Definition aligned with the OECD Guidelines
- Indian laws – Section 2 (11)(b) and Explanation (ii) of Section 92B (2) of the Income Tax Act, 1961

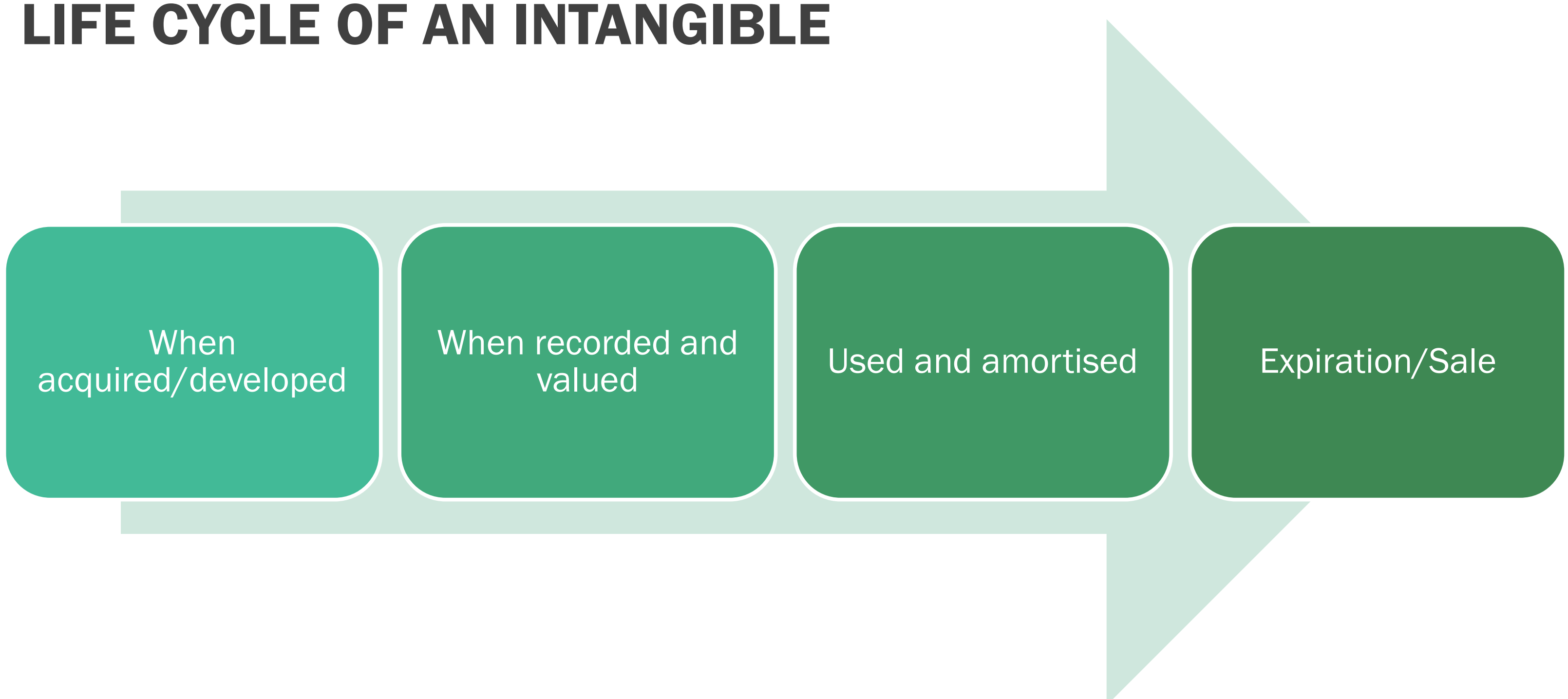
EXAMPLES/ILLUSTRATIONS OF INTANGIBLES (OECD TPG, PARA 6.18 TO 6.27)

- Patents;
- Know-how and trade secret;
- Trademark, trade names and brand;
- Rights under contracts and government licenses;
- Licenses and similar limited rights in intangibles; and
- Goodwill and ongoing concern value.

On the other hand, *group synergies* and *market specific characteristics* are not recognized as intangibles as they cannot be controlled by any party of the group. (OECD TPG, Paras 6.30 and 6.31)

All intangibles may not entail a royalty payment such as GOODWILL

LIFE CYCLE OF AN INTANGIBLE



Development of Intangibles

Contract R&D

- MNE might have a separate entity set up and then contracted to do R&D
- Set up in low tax jurisdictions
- Complex ownership
- Tax authorities look at control or risks assumed

CCAs/Cost Sharing

- Centralisation of development of intangibles
- Commercial considerations like efficiency and cost saving
- costs and benefits are shared proportionately

CATEGORIES OF INTANGIBLES

Manufacturing

- Manufacturing or Trade Intangibles are characterized as one of two types
  - Patented or
  - Not patented technical know how arising out of research and development Activity

Marketing

- Trademarks
- Corporate reputation
- Distribution network
- Ability to provide services
- Created by marketing activities
- Impact brand value

Registered IP, Non Registered IP

- IP which can be registered such as patents, trademarks
- IP which can contractually/legally protected like copyrights , design , trade secrets. Depending on local laws

Others

- Intangibles that are valuable to businesses but not legally protected or registered
- Substantially impact business and have to be considered in a transfer pricing analysis

“ROYALTIES” VS. “INTANGIBLES”

- the concept of royalties in article 12 “not intended to provide any guidance on whether and, if so, at what price the use or transfer of intangibles would be remunerated between independent parties”;
- **Characterisation:** the manner in which a transaction is characterised for transfer pricing purposes has no relevance to the question of whether a particular payment constitutes a royalty or may be subject to withholding tax; and
- the concept of intangibles for transfer pricing purposes and the definition of royalties for purposes of Article 12 of the OECD Model Tax Convention are two different notions that do not need to be aligned.

“ROYALTIES” VS. “INTANGIBLES”

- OECD Article 12 is applicable if any royalty payment;
- OECD TPG Chapter VI applicable for determination of arm’s length or flow of royalty;
- Most intangibles give rise to royalty payments;
- The form and methodology of calculation of the transfer price for the use of intangibles has an impact on article 12(4)

FORM OF PAYMENTS

- There are many ways to remunerate such licensing agreements, the simpler among them may be in these forms:

  (i) A fixed annual fee

  (ii) A fee based on a percentage of licensee's sales of the licensed products

  Such a payment is called royalty.

  Example: Denmark Co. has given IP for manufacture of Vito A(health supplement) in India to Indian subsidiary @ 4% of annual sales.

Vito C Sales	INR 2 crores
Vito A Sales	INR 5 crores
Total sales	INR 7 crores

COMMON ISSUES

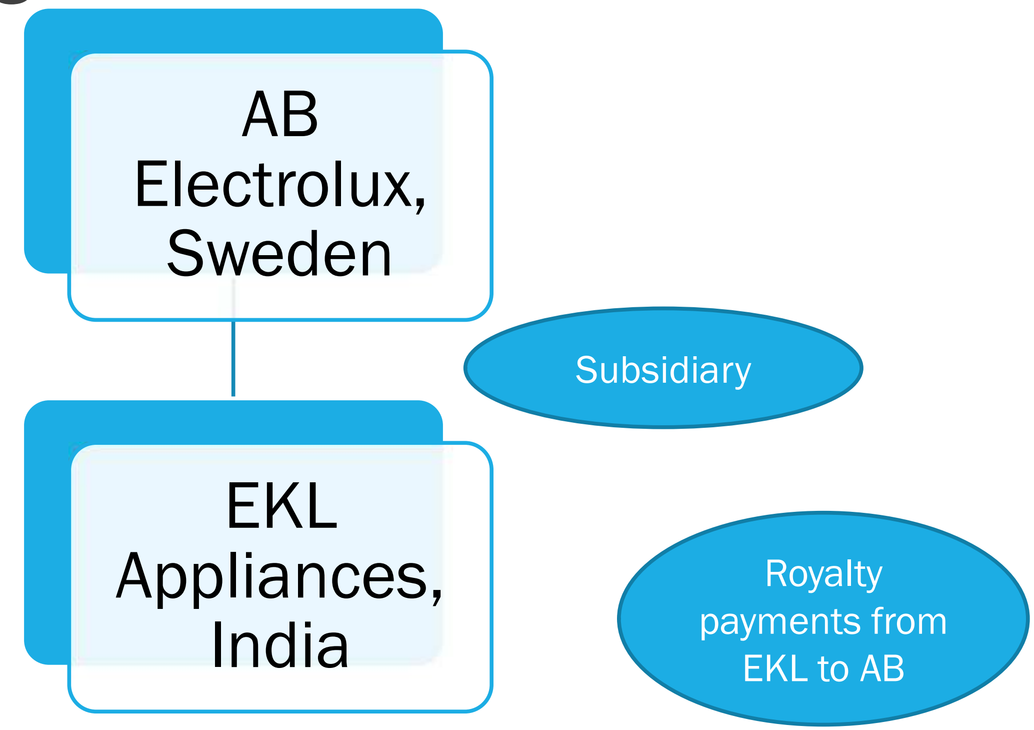
- Whether the payment of royalty from one of the related parties (typically located in a less developed country) is necessary or not?
- Whether the payment of royalty is excessive?
- Whether the economic ownership is same as legal ownership? Concept of substance over form
- Benefit test

BENEFIT TEST

- Justify that benefit is derived;
- TPO may disallow royalty payments if benefit not shown;
- Business and commercial expediency comes into play;
- Documents to support that IP actually received
- Evidence to support that the taxpayer received commensurate economic and commercial benefits

- CIT v. EKL Appliances Ltd. [2012] 345 ITR 241/209 Taxman 200/24 taxmann.com 199 (Delhi)
- Ericsson India (P.) Ltd. v. Dy. CIT [2012] 25 taxmann.com 472 (Delhi)

EKL APPLIANCES

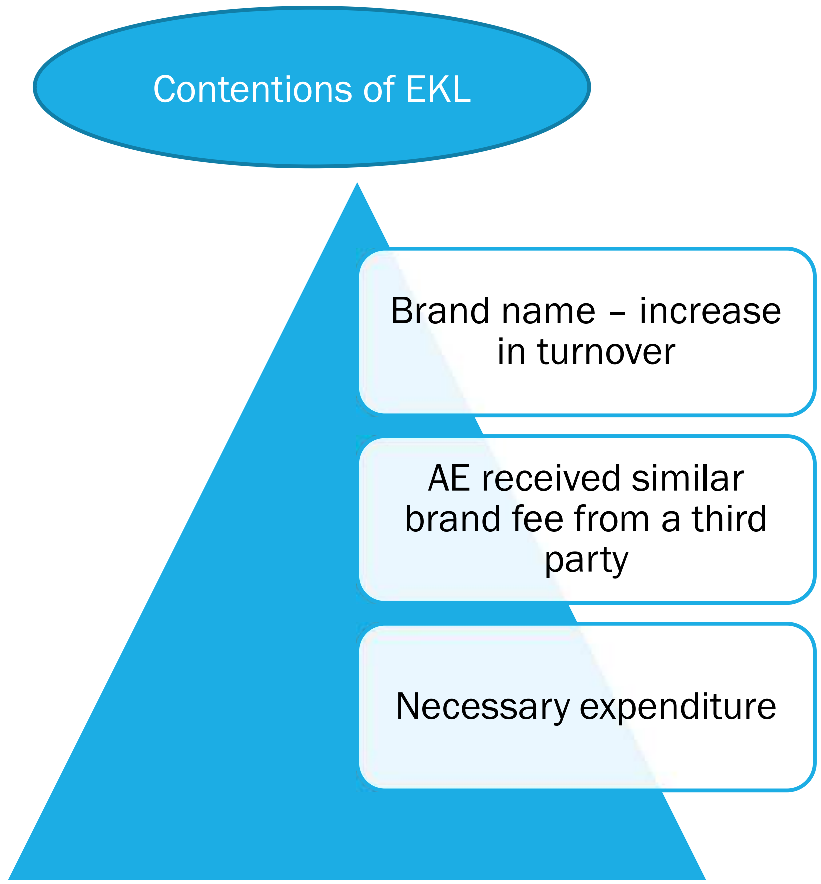


EKL APPLIANCES

Contentions of TPO

- Comparison of royalty did not prove arm's length
- Did not demonstrate actual benefit
- Losses and no increase in profit

EKL APPLIANCES



EKL APPLIANCES

- Appeal before the CIT(A):
- Due to high competition, EKL was forced to upgrade its technology
- Reduction of losses to a significant extent. Hence it can be inferred that EKL benefited from the payment of royalty to AE
- Deriving gross profit from the operations, it was suffering losses due to significant increase in expenses and other factors
- TPO has disregarded the business and commercial realities and strategies
- The TPO can not dictate the terms of business to EKL
- It is entirely upto EKL
- The CIT(A) deleted the adjustment made by the TPO.
- Appeal before the ITAT:
- In favour of the Taxpayer

EKL APPLIANCES

- **Appeal before the HC:**
- **The OECD Guidelines on the Transfer Pricing Regulations recognise that barring exceptional cases, the tax administration should not disregard the actual transaction or substitute other transactions in place of the actual transaction and the examination of a controlled transaction should ordinarily be based on the transaction as it has been actually undertaken and structured by the associated enterprises**
- **"recharacterization of a transaction is possible in only two situations - i.e. (i) where the economic substance of a transaction differs from its form and (ii) where the form and substance of the transaction are the same but arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner."**
- **Principles laid down in various caselaws enumerate that, for an expense to be considered to be genuine business expense, it is only necessary for the assessee to demonstrate that the said expenses have been incurred "wholly and exclusively" for the purpose of business and nothing more**

EKL APPLIANCES

- The TPO has to determine the quantum of the international transactions with regards to the arm's length principle as per the provisions of the law and the financial health of the assessee can never be a criterion to judge allowability of an expense.
- EKL has furnished detailed justification supported by facts and figures to demonstrate
- There is no material brought by the tax department during the course of the appellate proceedings to show that the facts and figures presented by EKL were incorrect or that the reasons for the losses are not genuine
- The HC upheld the royalty payment and the deletion of the adjustment made by the TPO

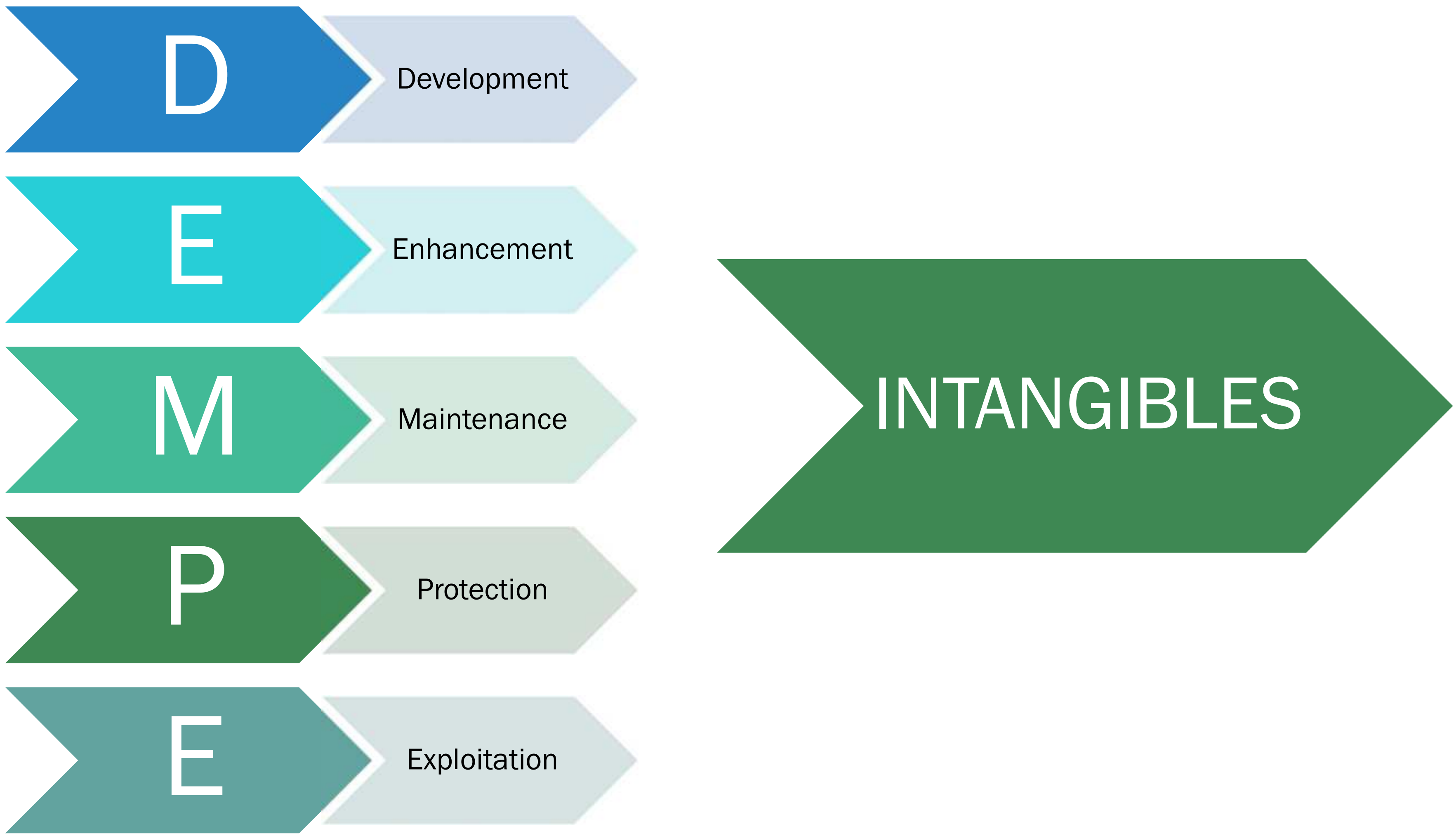
BENCHMARKING OF ROYALTY

- Arm’s length price of royalty:
- Method used: comparable uncontrolled price method (“CUP”) or Transaction Net Margin Method (“TNMM”)
- Databases available for comparable royalty data

EXAMPLE OF ROYALTY BENCHMARK

Related Company transaction	Unrelated company data
Royalty paid @ 5%	Company X @ 2%
	Company Y @ 3%
	Company Z @ 4%
	Average @ 3%

Related company paying much higher than industry unrelated company data. Will be subject to transfer pricing adjustments


D
Development
E
Enhancement
M
Maintenance
P
Protection
E
Exploitation
INTANGIBLES

DEMPE FUNCTIONS

- Taken into consideration by the UN and OECD for TP Analysis of transactions involving intangibles (Para 6.34):

I. Identify the intangibles and risks within a particular transaction

II. Identify the contractual agreements relating to the transaction in question

III. Identify which parties performed DEMPE functions, by means of a functional analysis

IV. Determine whether the conduct of the parties was consistent with the contractual assumption of risk

V. Delineate the actual controlled transactions relating to DEMPE

VI. Determine arm's length prices for the transactions

INDIAN PERSPECTIVE

- Circular 6/2013
- Decision of Delhi High Court dated 16.03.2015 in Sony Ericsson vs. CIT being ITA No. 16 of 2014
- FAR versus FARM – Has India added the 'M'

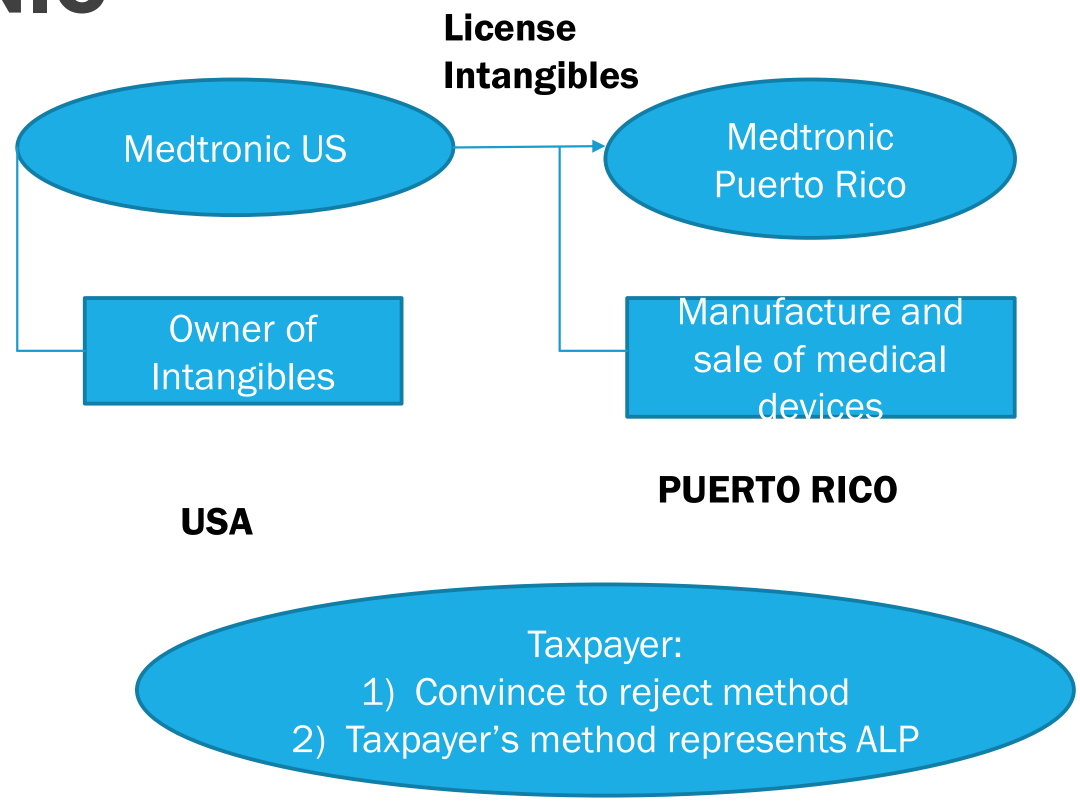
DECISION OF COCA-COLA

Contractual framework

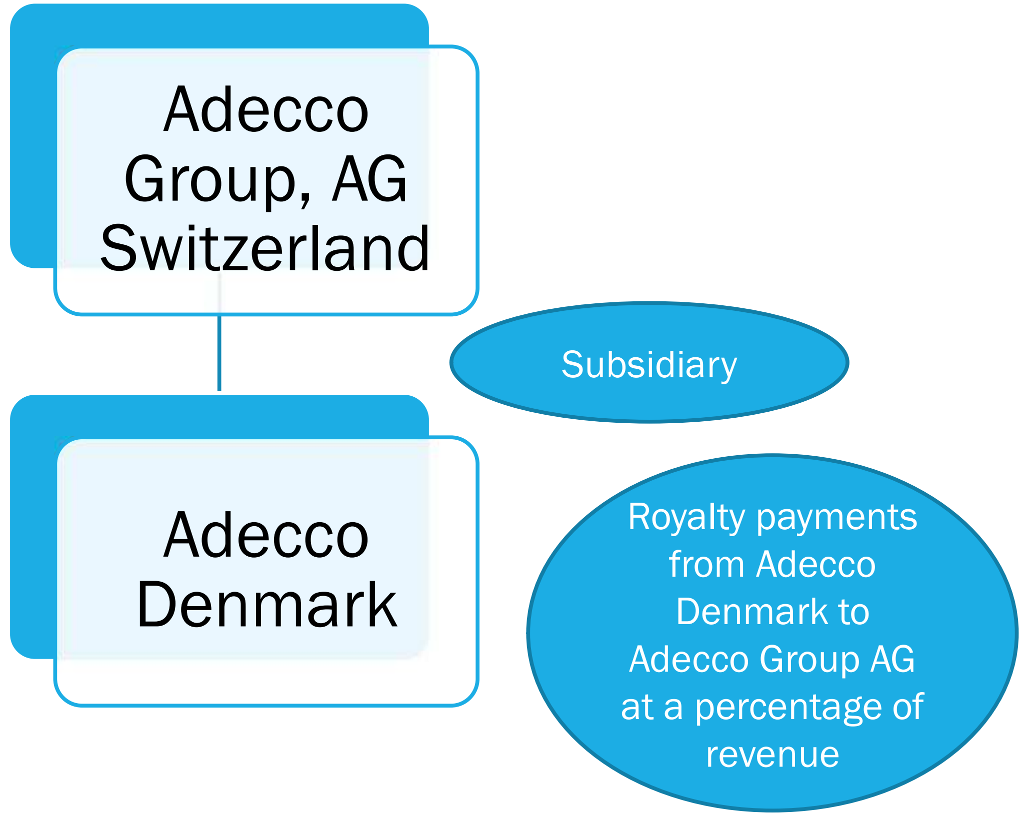
The Coca-Cola Company & Subs. v. Commissioner (2020) 155 T.C. No. 10

https://news.bloombergtax.com/daily-tax-report/coca-cola-failed-to-charge-arms-length-royalties-to-affiliates?context=search&index=7

MEDTRONIC


License Intangibles
Medtronic US
Medtronic Puerto Rico
Owner of Intangibles
Manufacture and sale of medical devices
PUERTO RICO
USA
Taxpayer:
1) Convince to reject method
2) Taxpayer's method represents ALP

ADECCO – DENMARK SUPREME COURT



ADECCO – FACTS

- Adecco Denmark claimed an amount of DKK 84 Million (around 100 crores INR) towards payment of royalties for the period of 2006-2009 as deductible operating cost
- The Danish Tax Administration, determined arm's length price ("ALP") of royalty payments for 2006 to 2009 by Adecco Denmark as nil and disallowed the deduction
- The National Tax Tribunal (NTT) and the High Court also ruled in favour of the tax authorities

ADECCO – HIGH COURT

- High Court's Decision
- Burden of proof to claim royalty payments as deductible operating cost lies on the Taxpayer
- Taxpayer needs to establish a nexus between royalty payments for the use of the Adecco trademark, know-how, and access to customer referrals and the income earned by the company from access to international network of the Group Company
- Significant marketing cost incurred by assessee demonstrated lack of international value to the brand licensed by parent entity
- Also, access to global customers or international network did not result in material benefit to assessee, as it contributed to less than 11% of overall revenues for Adecco Denmark.
- Therefore, the arm's length royalty paid by Adecco Denmark was upheld to be Nil

ADECCO – DENMARK SUPREME COURT

Supreme Court's Decision

Questions before Supreme Court

- **Whether Adecco Denmark's payment of royalties is a deductible expense?**
- **Whether Adecco Denmark's TP documentation suffers from such deficiencies that the Danish Tax Agency has been entitled to assess the royalty rate at its discretion?**
- **Whether the agreement on the royalty rate has been entered into on arm's length terms?**

ADECCO – DENMARK SUPREME COURT

- **Supreme Court's Decision**
- **Reversed the decision of the High Court**
- **Documentation was found to be sufficient**
- **Accepted internal CUP arrangements'**

VALUATION OF INTANGIBLES

- OECD Based on BEPS Action Plan 8 has released a Guidance on Guidance for Tax Administrations on the Application of the Approach to Hard-to Value Intangibles
- Valuation of intangibles involves an element of subjectivity and therefore often scrutinized by tax authorities
- Economic value is based on the economic and legal environment in which the intangibles are created and exist
- Assumption are made for valuation
- Refer to Paras 6.182 to 6.184 of the OECD TPG

**OECD (2018), Guidance for Tax Administrations on the Application of the Approach to Hard-toValue Intangibles - BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-tohard-to-value-intangibles-BEPS-action-8.pdf*

HARD-TO-VALUE-INTANGIBLE (HTVI)

- An HTVI is an intangible for which a comparable uncontrolled transaction (CUT) does not exist and for which projections will be necessary.
- Defined at Para 6.189 of the OECD TPG to include intangibles or rights in intangibles for which at the time of the transaction
- (i) no reliable comparable exist, and
- (ii) the projections of future cash flows or expected income, or the assumptions used in their valuation are highly uncertain.

FOOD FOR THOUGHT !

- Almost all intangibles seem to fall in the category of HTVI.
- However, the OECD has given examples that shed some light on the HTVI definition.
- For example, intangibles that are only partly developed, intangibles whose commercial exploitation will only take place after several years, and intangibles that will be exploited in a manner that is novel may be mentioned as examples. (Para 6.190)

FEATURES OF HTVI

- The intangible is only partially developed at the time of the transfer.
- The intangible is not expected to be exploited commercially until several years following the transaction.
- The intangible does not itself fall within the definition of HTVI in paragraph 6.189 but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.
- The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.
- The intangible, meeting the definition of HTVI under paragraph 6.189, has been transferred to an associated enterprise for lump sum payment.
- The intangible is either used in connection with or developed under a CCA or similar arrangements.

CASE STUDY 1

- Prathamika is the parent company of an MNE group. Prathamika has been engaged in several large litigation matters and its internal legal department has become adept at managing large scale litigation on behalf of Prathamika. In the course of working on such litigation, Prathamika has developed proprietary document management software tools unique to its industry. Company S is an associated enterprise of Prathamika. Company S becomes involved in a complex litigation similar to those with which the legal department of Prathamika has experience.
- Prathamika agrees to make two individuals from its legal team available to Company S to work on the Company S litigation. The individuals from Prathamika assume responsibility for managing documents related to the litigation. In undertaking this responsibility they make use of the document management software of Prathamika. They do not, however, provide Company S the right to use the document management software in other litigation matters or to make it available to Company S customers.
- Will royalty be charged?

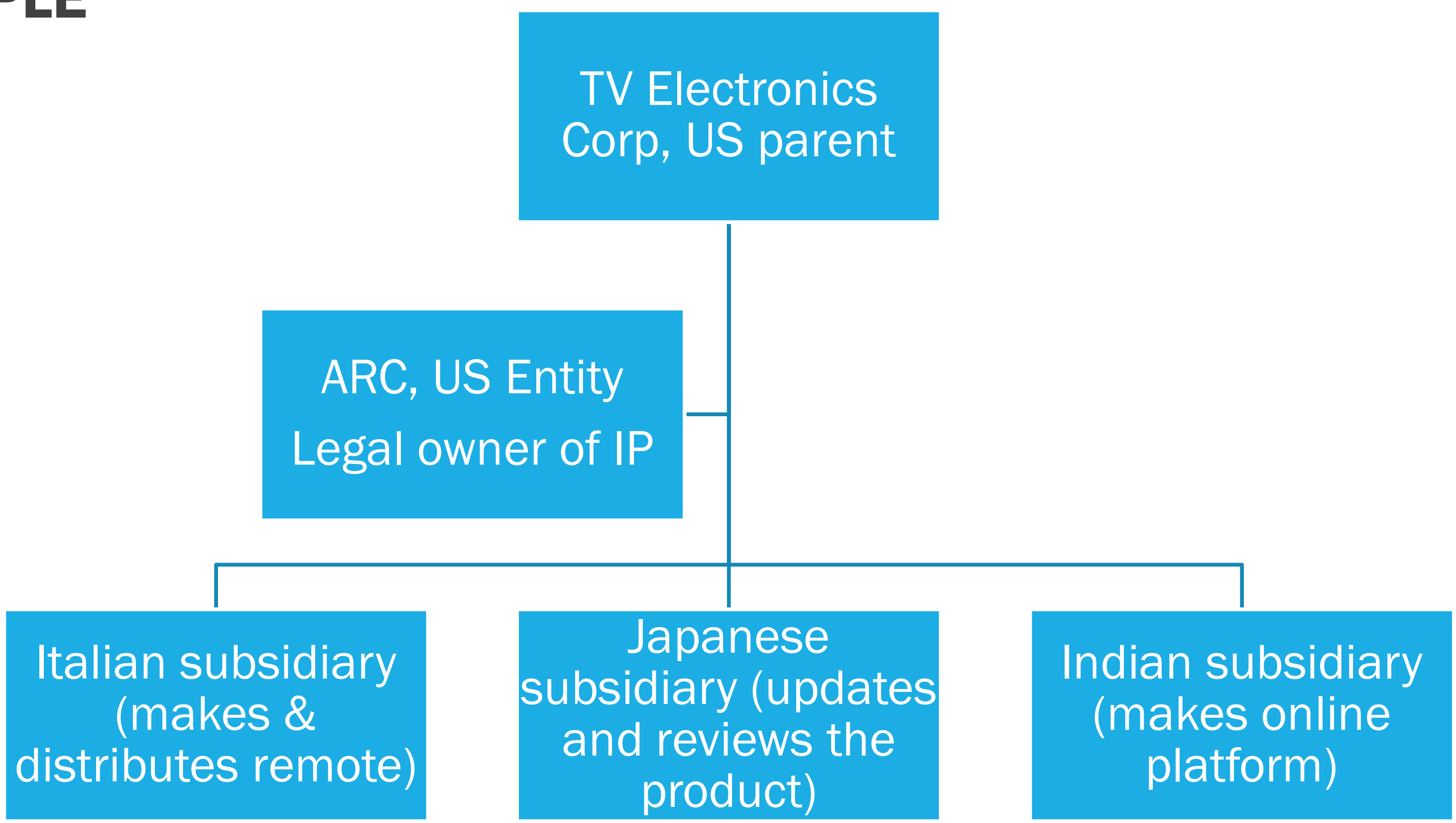
CASE STUDY 2

- Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. The Shuyona group maintains R&D centres to improve existing products and develop new products. The Shuyona R&D centre designs research programmes, develops and controls budgets, makes decisions as to where R&D activities will be conducted, monitors the progress on all R&D projects and, in general, controls the R&D function for the MNE group, operating under strategic direction of Shuyona group senior management.

- Shuyona sells all rights to patents and other technology-related intangibles to its newly incorporated subsidiary, T, and, at the same time, T enters into a contract research agreement with Shuyona. Pursuant to this research agreement, T contractually agrees to bear the financial risk associated with the possible failure of future R&D projects, agrees to assume the cost of all future R&D activity and pays a remuneration service fee based on the cost of the R&D activities undertaken, plus a markup. However, T does not have the technical personnel capable of conducting or supervising the research activities, and Shuyona continues to develop and design the R&D programme related to further development of the transferred intangibles.

- Discuss the transfer pricing implications of the above

EXAMPLE


TV Electronics Corp, US parent
ARC, US Entity
Legal owner of IP
Italian subsidiary (makes & distributes remote)
Japanese subsidiary (updates and reviews the product)
Indian subsidiary (makes online platform)

ROYALTY-INCOME TAX ACT, 1961

ROYALTY

- Phenomenon of “Royalty” has a historical origin. It was equated with the royal prerogative in early centuries. It originates from the French words [roialte, or roial]. It was the sense of ‘royal right (especially over minerals’) which got further developed into the sense of payment made by a mineral producer to the site owner, Meaning of “Royalty” further expanded to include payments for the use of patents and published materials.
- Investopedia Dictionary defines “Royalty” – A royalty is a payment to an owner for the use of property, especially patents, copyrighted works, franchises or natural resources. A royalty payment is made to the legal owner of the property, patent, copyrighted work or franchise by those who wish to make use of it for the purposes of generating revenue or other such desirable activities.

- Income Tax Act, 1961 includes royalty income under section 9(1)(vi).

EXPLANATION 2 TO SECTION 9(1)(VI)

- As per explanation 2 to Section 9(1)(vi)—For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—
- (i) the transfer of all or any rights (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 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 ;
- (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;
- 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).

DEFINITION OF ROYALTY

- Royalty is generally a payment received by the owner of an **intangible right or knowhow** under license in any technology transfer. Such intangible rights are often for making use of **intellectual property**
- **Outright sale vs Royalty**
- **Intellectual property;**
- **Proprietary rights**

KEY TERMS USED IN THE DEFINITION OF ROYALTY

Key terms used in definition of Royalty:

- Copyright and copyrighted article
- Patent and trademark
- Plan, design or model
- Secret formula or process
- Industrial, commercial or scientific equipment
- Information concerning industrial, commercial or scientific experience

ENGINEERING ANALYSIS *CENTRE OF EXCELLENCE PRIVATE LTD V COMMISSION OF INCOME TAX {INDIAN SC-2021}*

End User	Distributor	Sub-Distributor	Software in a hardware
Indian end users who purchase the Software directly from a foreign non-resident supplier or manufacturer	Indian resellers who purchase computer software from non-resident suppliers for the purpose of resale in India	Non-resident vendors, who, after purchasing software from other non resident sellers, resell the same to resident Indian distributors or end-users	Non-resident suppliers who affix computer software onto hardware and then sell the same as an integrated unit to resident Indian distributors/ end users

CASE LAWS

- *DIT v Infrasoft Ltd* (ITA No. 1034/2009)
- *Engineering Analysis Centre of Excellence Private Ltd v Commission of Income Tax* (23 ITLR 569)
- Australian case *Task Technology Pty Ltd v Commission of Taxation* [2014] FCA 38;
- Delhi High Court (in *DIT v New Skies Satellite BV* ITA 473/ 2012);
- *Tech Mahindra v Commissioner of Taxation* (20 ITLR 70 – September 2016);
- Australian case of *Satyam Computer Services Ltd v Commissioner of Taxation* [2018] (21 ITLR 274)

QUIZ

QUERIES

YOUR

QUESTIONS

PLEASE !!!

THANK YOU!

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