Royalties

Definition and Allocation Rules under DTAAs

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Royalty – Definition u/s 9(1)(vi) of the Act

Consideration, including lumpsum consideration (other than income chargeable as capital gains) for	the transfer of all or any rights (including the granting of a licence) in respect of
	the imparting of any information concerning the working of, or the use of,
	Use of
	Imparting of any information concerning
	Use or right to use of
	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 ;

Technical, industrial, commercial or scientific knowledge, experience or skill

Any industrial, commercial or scientific equipment (excluding section 44BB)

Copyright, literary, artistic or scientific work (excluding sale, distribution or exhibition of cinematographic films)

Royalty also includes income from rendering of services in connection with above

Royalty u/s 9(1)(vi) of the Act

Royalty deemed to accrue or arise in India when

- Payable by the Government
- Payable by resident to non-resident, except
  - where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person (i.e., the payer) outside India
  - for the purpose of making or earning any income from any source outside India
- Payable by non-resident to resident, only if
  - the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India
  - for the purpose of making or earning any income from any source in India

Royalty u/s 9(1)(vi) of the Act

Retrospective amendments made by Finance Act, 2012 with effect from 1 June, 1976

- Explanation 4
  - Transfer of all or any rights in respect of any right, property or information includes transfer of all or right for use or right to use a computer software (including granting of a license) irrespective of the medium through which the right is transferred
- Judgements sought to be overruled by Explanation 4: Ericsson AB (2012), 343 ITR 470 (Delhi), Nokia Networks OY (20120) 25 taxmann.com 225 (Delhi)

Royalty u/s 9(1)(vi) of the Act

Retrospective amendments made by Finance Act, 2012 with effect from 1 June, 1976

- Explanation 5
  - Royalty includes consideration in respect of any right, property or information, whether or not
    - The possession or control is with the payer;
    - It is used directly by the payer;
    - Location is in India
- Explanation 6

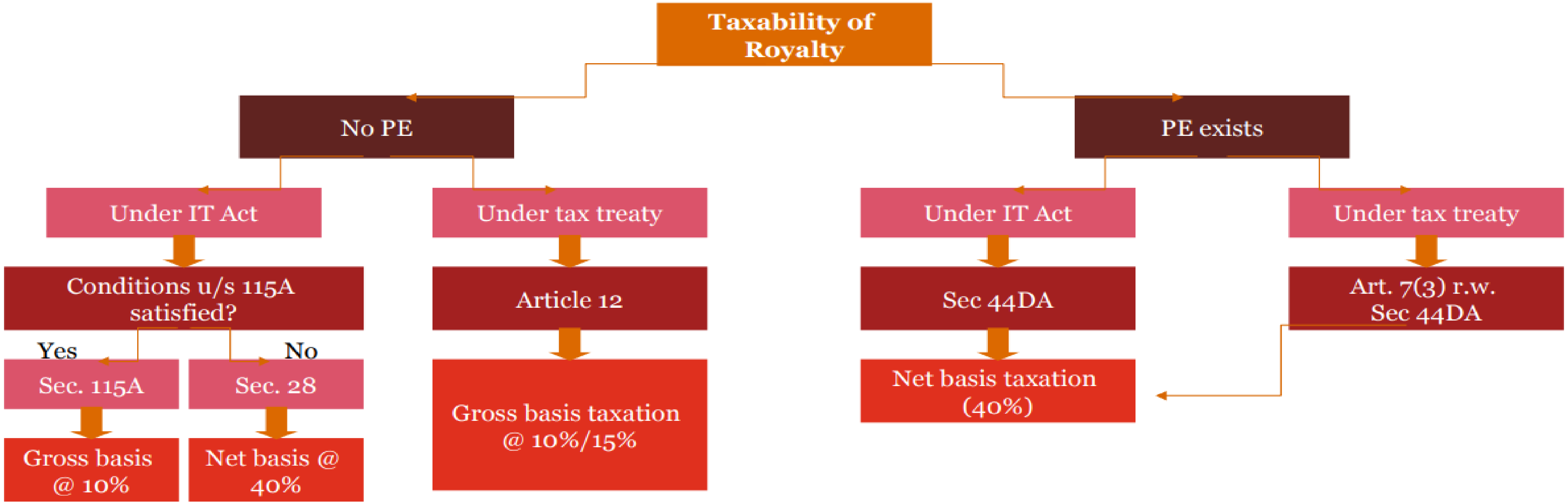
  - "Process" includes transmission by satellite, cable, optic fibre or by any other similar technology, whether or not such process is secret
- Judgements sought to be overruled by explanation 5 and 6: Asia Satellite Telecommunications Ltd. (2011) 332 ITR 340 (Delhi), ISRO Satellite Centre (2008) 307 ITR 59 (AAR)

Taxation of Royalty under the Act

Royalty taxable @ 10% (plus surcharge and education cess) on gross basis u/s 115A if
- Received by non-resident from a resident; and
- Non-resident does not have a PE in India

• Royalty taxable @ 40% (plus surcharge and education cess) on net income basis under 44DA of Act if
- Received by non-resident from government/Indian concern; and
- Non-resident has a PE in India and the right/property/contract in respect of which Royalty /FTS are paid, is
effectively connected with the PE

Current Taxation Regime for Royalty



Royalty under OECD and UN Model Conventions

OECD (Residence Based Taxation)	UN (Source Based Taxation)
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.	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 the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

Royalty under US Model

The term "royalties" as used in this Convention means:

- Any consideration for **the use of, or the right to use**, any copyright of literary, artistic, scientific or other work (**including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction),** any patent, trademark, design or model, plan, secret formula or process, or any other like right or property, or for information concerning industrial, commercial, or scientific experience; and

- gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use or disposition of the property

Words in red are deleted from the 2016 US model

Royalties under Indian Tax treaties

Country	Definition
Singapore	Includes gains from alienation of right, property or information
USA	Includes gains derived from the alienation of right or property which are contingent on the productivity, use, etc.
Singapore, USA and Canada	Rental of Ships or Aircrafts / Containers incidental to any activity directly connected with operation of ships / aircrafts in international traffic specifically excluded from Royalty
Morocco, Namibia, Russia, Trinidad & Tobago, Turkmenistan, Kazakstan and Kyrgyz Republic	Specific inclusion of software
Libya	Rental and other income from cinematograph films considered as business profits and not Royalties
Greece, Israel, Sweden	Does not include 'Equipment Royalty'
Belgium, France, Kazakhstan, Netherlands, and Spain	Does not include 'Equipment Royalty' – MFN clause

Typical structure of Royalty article under Indian tax treaties

- Article 12(1) – State of residence to have right to tax royalty
- Article 12(2) – State of source also to have right to tax royalty, however ceiling of tax rate by the state of source subject to Beneficial Ownership
- Article 12(3) – Meaning of the term 'Royalty'
- Article 12(4) – Taxation of Royalty if effectively connected with PE / Fixed Base of Non-Residents in the State of Source
- Article 12(5) – Arising of Royalty in the State of Source
  - Where payer is Resident; and / or
  - If the Payer has a PE / Fixed Base in the State of Source and the Royalty is connected and borne by such PE / Fixed Base
- Article 12(6) – Adjustments for related party transactions - Excess over Arm's-length price to be taxable as per domestic provisions

Allocation rules - Overview

- Cross border commerce gives right to at least two countries to tax income earned by the tax payer •
- These are – Source Country and Residence Country
- Source Country claims right to tax on the ground that income is earned there, and they are entitled to tax it
- Residence Country generally has the right to tax the global income of its residents (US taxes even its non resident nationals)
- As double taxation may make commerce unviable, countries enter into DTC/DTAA
- DTC allocates taxing rights amongst both countries based on mutual negotiations
- Under the DTC, either a country gives up its right to tax a particular type of income, or restricts its right to tax it at a lower rate, leaving scope for the other country to collect a part of the tax
- Credit method and exemption method

Allocation Rules – Royalties – Article 12(1)

- Royalties and fees for included services arising in India and paid to a resident of the USA may be taxed in the USA.
  - Royalties arises in Source State
  - Paid to the resident in Resident State
  - May be taxed in State of Residency
- Residential Status of Recipient to be determined by Article 4
- Term paid – to include paid/payable/legally accrued/exchange
- Physical payment necessary or not?
- May be taxed – Option to Residential State – Credit/Exemption – DTAA Relief

Allocation Rules – Royalties – Article 12(2)

- However, such royalties and fees for included services 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 or fees for included services is a resident of the other Contracting State, the tax so charged shall not exceed
- Royalties arising in India may be taxed in India too
- Beneficial Owner of royalties to be resident in State of Source i.e. India
- Capping on rate of tax
- Recipient of Income in form of Royalty to not to have a PE or fixed base in India

Beneficial Ownership

- OECD

- Term not to be used in a narrow or technical sense but object and purpose of tax conventions

- IBFD

- common law term developed by the Courts and is distinct from 'Legal Owner'

- US Model Technical Explanation

- Not defined in the convention – to be interpreted as per domestic law of source state

- Indian context

- CBDT Circular 789 dt .3 April 2000 - Tax Residency Certificates issued by Mauritius Tax Authorities sufficient evidence of residence status as well as Beneficial ownership
- Whether the circular can be applied in case of royalty also?
- TRC was held to be sufficient evidence for beneficial ownership Universal International Music B.V (45 SOT 219) (Mumbai); appeal not admitted by Bombay High Court (214 Taxman 19)
- New Rules for Form 10F along with TRC

Annexures

Common types of IPR

	Meaning	Few Examples	Legislations
Patent	Rights granted in relation to an invention to protect its commercial exploitation by others	Chemical / Pharmaceutical products	Patents Act, 1970
Copyright	Exclusive right with respect to literary, artistic, etc. work	A painting, book, piece of music, film	Indian Copyright Act, 1957
Trade mark	Distinctive sign that identifies goods / services of an enterprise	Logos of McDonalds, Coco Cola	Trade Marks Act, 1999
Design	Features of shape, pattern, etc. – includes element of industrial production	Drawings of cartoon characters	Designs Act, 2000

Examples – How to identify

Product	IPR	Licensee of IPR gets	Purchaser of product gets
T.V. shows	Right to Telecast	Right to telecast	Entertainment
Medicines	Patent	License to manufacture and sell medicines	Ownership of medicine
Books	Copyright	License to publish i.e make copies and sell	Ownership of book
Packaged food	Trademark	Franchisee gets right to manufacture and sell under trademark	Ownership of product
High Definition TVs	Patent, Design	License to manufacture and sell	Ownership of product

Royalty
Taxed on gross basis; on net basis if effectively connected with PE

Business income
Taxed on net basis if PE/business connection

Examples of Royalty

- Licence to reproduce software and distribute it to the public; Access to a portal located outside India in specified circumstances; Use or right to use customized software; Use of an internet based software hosted on the server of a foreign company in specified circumstances; Use or right to use a design, secret formula, patent, trademark, invention, etc.; Payment for time charter or bareboat charter of a ship; Payment for sharing of standard operating procedures developed over a period of time.

Examples of payments not Royalty

- Sale of off the shelf software; □ Use of leased capacity of a transponder; □ Outright sale of engineering designs, calculations, etc.; □ Transmission of voice and data through telecom bandwidth; □ Access to data in a copyrighted web based database. □ Sale of business information reports; □ Sale of industry information; □ Access to a web-based journal containing views, opinions and news □ Providing grading and certification reports; □ Data processing services in cases where it is a standard facility; □ Assignment of rights in a contract; □ Cost contribution towards basic R&D activities □ Data storage space charges