ITR WORLD TAX

India: Intra Group Royalty – A showstopper in Transfer Pricing Arena!

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A. Introduction

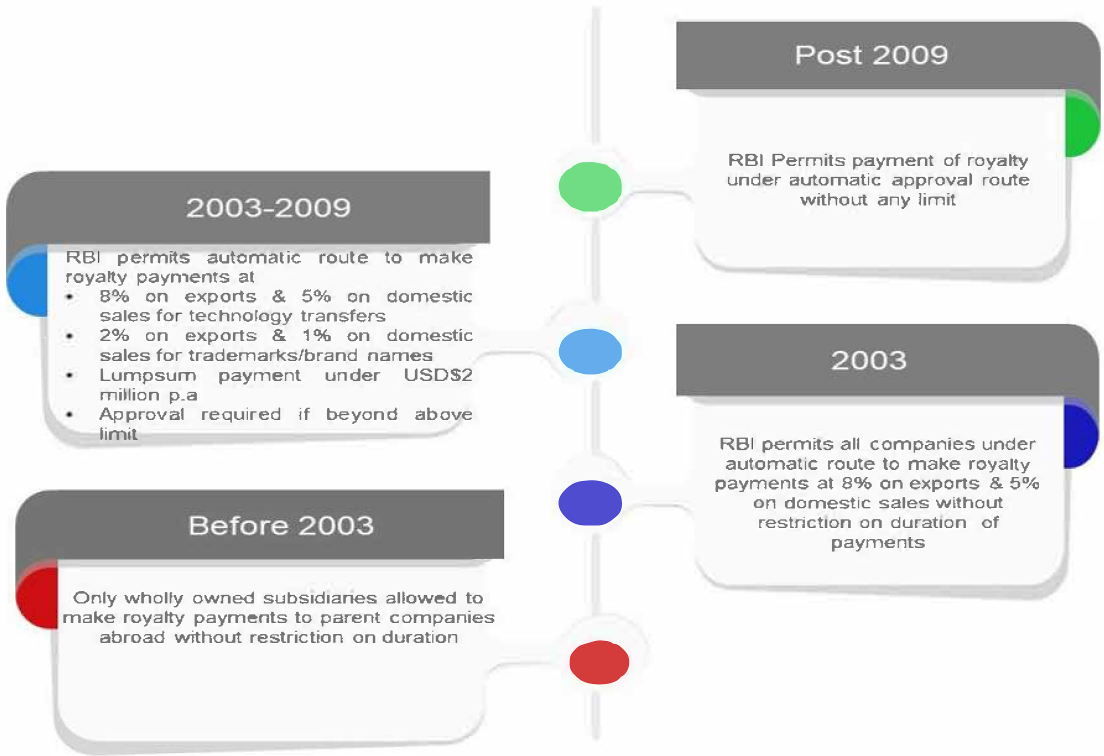
Royalty payments to Group Entities for the use of Intangible property have always been in limelight. The fast paced growth of the intangible economy with the world royalty and licensing fee receipts recorded at 494 Billion USD in 2023 as compared to 191 Billion USD in 2010 as reported by the World Bank, has opened up the pandora's box posing new and unique challenges in determination of the arm's length price in relation to transactions involving intangibles. This is rightly so because of the special characteristics of intangibles which pose significant constraints in identifying proper comparables as they are seldom traded and are often bundled with other tangible transaction making it a lot more for difficult for identification and delineation. In this backdrop, this article delves into the regulatory history of royalty payments in India and the recent litigation trends with an intent to provide businesses an overview of the approaches to defend royalty.

B. Evolution of Indian regulatory environment governing royalty payments

Recognising the need for newer technology and to rationalise the manufacturing processes, the Government permitted the remittance of royalty for use of technologies/ trade name and brand within specified limits and subject to certain conditions under automatic approval route.

The below chart summarises the history of regulatory provisions governing the payment of royalty over the years.

<u>History of Regulatory Provisions governing Royalty Payments</u>



Post 2009, There has been a substantial increase in licensing of IP rights leading to increasing royalty payments by Indian group companies to its foreign parent thus eliciting such transactions to be one of the most grappling issues in the Indian Transfer Pricing realm.

The recent market regulator, SEBI's Report has further shed more limelight to this topic by revealing that royalty payments made by listed companies to their related parties (RPs) have more than doubled over the past 10 years, with one out of every 10 listed companies paying royalty in excess of 20% of their net profit.

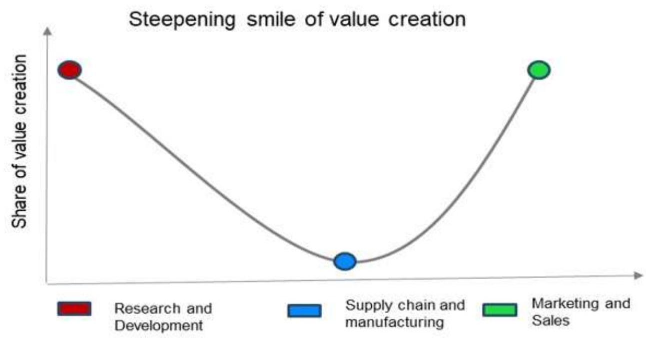
In light of the above developments, the need for evaluation of international transaction ("IT") involving the transfer/ licensing/ use of IP assumes significant importance.

C. Intangibles and Value creation

Intangibles play a critical role in the global value chain. While there are several business tools and models, the Value Chain analysis formulated by Michael Porter is a key tool for understanding value creation. The value chain disaggregates a Group into its strategically relevant activities in order to understand the behaviour of costs and the existing and potential sources of differentiation as in below figure.

Intangibles are inputs in all the above functions carried on by a business. While the first function namely research and development leads to creation of unique Trade intangibles that are used in 2 & 3 namely supply chain and manufacturing activities by way of licensing arrangements, marketing intangibles are created while performing marketing and sales function through market research and building brand equity.

Thus its is evident that the R&D and Marketing activities create substantially more value addition in Global Value chain analysis than those in the middle of the value chain namely supply chain and manufacturing activities as they result in the development of intangibles, leading to the concept of smile value creation.



D. Transfer Pricing of Royalty Transactions

Generally, the Indian subsidiaries of the foreign MNCs are engaged in functions like supply chain management, manufacturing, provision of services etc which fall in the middle of Porters value chain analysis as depicted above. Accordingly, the intangibles are generally licensed by the Foreign Group entities to their Indian Subsidiaries warranting a payment in the form of royalty for use of such licensed intangible. Post 2009, with relaxation and removal of the royalty cap, the payment of royalties to related parties have increased and has become a prime matter of litigation.

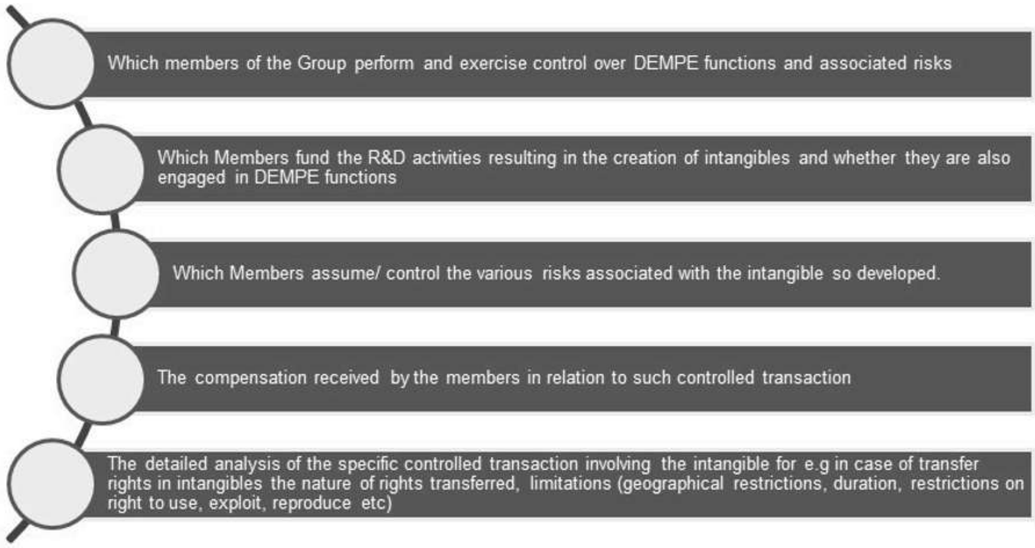
E. Litigation Trends

Some of the most litigated areas involving Royalty payouts have been highlighted below.

1. Benefit Test

The Indian Tax Authorities often challenge the need for royalty payment requiring the taxpayer to substantiate the economic and commercial benefits (i.e. which are Tangible and quantifiable) derived as a result of licensing such intangible and whether such royalty payments are aligned to the value creation. In this regard reference is made to Action Plan 8 of the OECD BEPS guidance, which requires the transfer pricing outcome i.e. the profits associated with the transfer and use of intangibles to be appropriately aligned in accordance with the value creation.

Accordingly a comprehensive value chain analysis is critical to substantiate the arm’s length nature of royalty payment. This analysis involves identifying the relevant intangibles, the value creation arising out of the transactions under review, the functions performed and the risks assumed in connection with the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles and the manner in which they interact with other intangibles, tangible assets and with business operations to create value. Some of the critical aspects that needs to be evaluated here are:



It is to be noted that many at times, the payment of royalty by the taxpayer may not yield quantifiable tangible benefits immediately but may be result in future benefits which may pose difficulty in substantiating the royalty payment. The onus to provide necessary information required to substantiate the need and the resultant benefit from such royalty arrangements is thrusted on the Taxpayer. However the Indian Courts have upheld decisions in favour of the Taxpayer questioning the authority of the Transfer Pricing officer in concluding the commercial expediency of an International transaction.

The Section below highlights few noteworthy case laws relating to benefit test including payment of royalty in loss scenarios. It is pertinent to note here that in majority of the cases the ruling has been in favour of the Taxpayer while in few cases the matter has been remanded back to the TPO for fresh assessment.

In the case of EKL Appliances Ltd, the Delhi High Court held that the TPO was not justified in disallowing brand fee because assessee had been continuously incurring huge losses. It held reasonableness to be seen from point of view of business man and further held that "it is not necessary to show that the expenditure was a profitable one or that in fact any profit was earned".

In the case of Samsung India Electronics (P.) Ltd, the Delhi HC emphasised the transfer pricing principle that it is necessary to understand the substance of a business arrangement rather than its form to determine whether transactions between related parties are on arm’s length terms or are undertaken with a view to derive undue tax benefits and/or to shift profits. The HC also indicated that the tax authorities do not have the right to step into the shoes of the taxpayer and question the commercial expediency or genuineness of the need for a transaction.

<u>INTERNATIONAL JURISPRUDENCE ON BENEFIT TEST</u>

I. Greece vs “Dairy Distributor S.A [In favour of Revenue]

Dairy Distributor S.A.” produces a variety of dairy products and sells to consumers in the Greek market products produced in its own factory or by other Group companies. For the rights to use the trademarks and know-how for its production and sales activities, “Dairy Distributor S.A.” had entered into a trademark licence agreement and a know-how licence agreement with a related party in the Netherlands and until 2017 paid a royalty for the use of trademarks of 2% on net sales and a royalty for the use of know-how of 2% on net sales of locally produced products. In 2018, “Dairy Distributor S.A.” was changed from a limited risk distributor to a full risk distributor and was now also required to pay royalties for know-how on net sales of products that it did not produce itself. The tax authorities disallowed deductions for these additional royalty payments, concluding that these did not comply with the arm's length principle or qualify as payments for genuine know-how rights. The authorities also disallowed the deductions for these payments as intra-group services, as they found no evidence that these services conferred a distinct, additional benefit to the local entity – particularly as it already possessed the expertise needed to sell the products."Dairy Distributor S.A." appealed to the Directorate of Dispute Settlement.

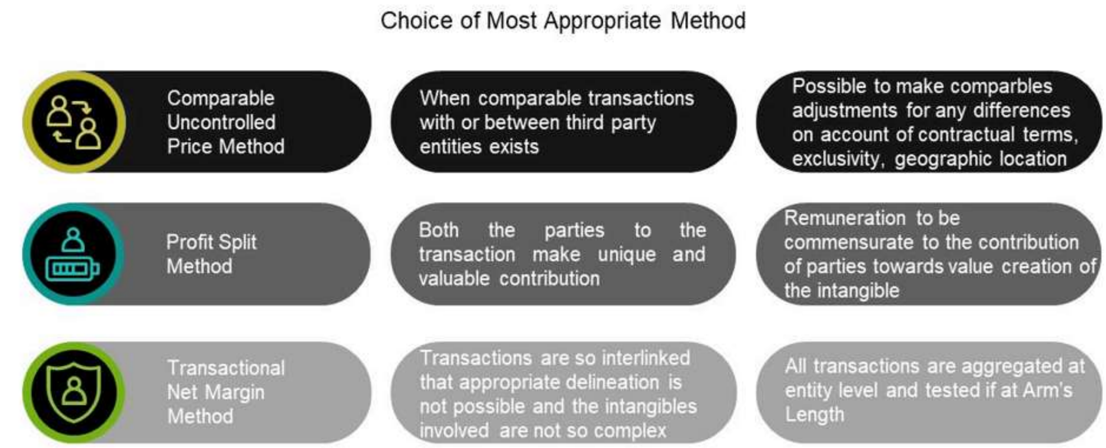
The Directorate rejected the appeal and confirmed the tax assessment issued by the tax authorities.

II. Korea vs "No Royalty Corp" [In favour of Revenue]

No Royalty Corp had a trademark registered in its own name. The trademark was used by other companies in the group, but no royalties or licence payments were received. Following an audit, the tax authorities issued a notice of assessment in which royalties had been added to the taxable income of the company in accordance with the arm's length principle. "No Royalty Corp" filed an appeal claiming that the trademark was developed and owned by all companies in the group and therefore no payments should be made for the use of the trademark. The Court upheld the assessment issued by the tax authorities. According to the court, it lacked economic rationality for the owner of the trademark to allow other companies to use its trademark without receiving any compensation.

2. Choice of MAM

The selection of the most appropriate method in a transaction involving transfer /use of intangibles, is based on the functional analysis and the comparability analysis, which will reveal whether sufficiently reliable comparables exists to permit the determination of arm's length conditions or not. Generally the Comprable Uncontrolled Price Method (CUP), Profit Split Method and the Transactional Net Margin Method are most commonly used method for determination of ALP in respect of transactions involving intangible.



Generally mere presence of intangibles does not imply that a separate arm's length compensation distinct from the required payments for goods and services is essential. However the aggregation approach is regularly contested by the tax authorities and a separate Royalty benchmarking is expected to be provided by the assessee. While there are decisions both in favour of and against the Taxpayer in aggregating the transactions and applying the TNMM Method, the decision whether to do a separate Benchmarking Analysis depends on whether appropriate delineation of transactions are possible and the complexity of the intangibles involved.

Few related case laws pertaining to choice of most appropriate method have been highlighted here below:-

I. The Bombay High Court in the case of Cummins India Ltd and the Tribunal decision in the case of Mercedes benz India held that the transaction of payment of royalty for use of technology was inextricably linked with manufacturing activity and should be aggregated with other international transactions in manufacturing segment for purposes of benchmarking same.

II. ASB International (P.) Ltd. v. Deputy Commissioner of Income-tax [2023] 151 taxmann.com 491 (Mumbai - Trib.) - [In Favour of Taxpayer]

The Mumbai ITAT held that in a scenario where it is difficult to identify the comparables under CUP method and the search in Public database has not thrown appropriate comparables and looking to the unique and valuable intangibles which has been licensed to the assessee, one cannot upheld the CUP as the most appropriate method in the case of the assesse. Accordingly, it is held that 'other method' would be a good substitute for CUP as there is lack of reliable comparables and looking to the fact that the royalty payments have been made for unique intangibles, therefore, the TPO was directed to adopt 'other method' as the Most Appropriate Method.

<u>INTERNATIONAL JURISPRUDENCE ON CHOICE OF MOST APPROPRIATE METHOD</u>

III. Mauritius vs Avago Technologies Trading Ltd

Avago Technologies Trading Ltd is active in the semiconductor industry and licenses intellectual property under a licence agreement with GEN IP, a related party in Singapore. This agreement allows Avago to sublicense the manufacture of Avago products to both related and unrelated parties. The issue was whether the royalty payments made by Avago to GEN IP were at arm’s length. The tax authorities determined that the payments were not at arm’s length and issued an assessment of additional taxable income. In order to determine the arm’s length royalty payments, the tax authorities disregarded the TNMM method used by Avago and instead used the CUP method. Avago filed an appeal with the Assessment Review Committee (ARC).

The ARC found all the Grounds of representations of the Applicant to be devoid of any merit and ruled in favour of the Respondent. The Committee found that the Transactional Net Margin Method (TNMN) method used to attribute all residual profits to IP was not properly done, The Committee further considered that that the royalty was purposely inflated beyond an arm’s length amount for the sole/dominant purpose of the Applicant (and GEN IP in Singapore) obtaining a tax benefit in Mauritius.

3. Payment of year-on-year royalty by well established companies in absence of additional enhancements to the existing technology.

Payment of year on year royalty in the absence of additional enhancements to the licensed technology is often contested by the Tax Authorities. The taxpayer in such cases would be required to provide evidence that such technology is patented and forms an integral part of the core operation of the business and cannot be licensed from any other third party. In addition, the enduring benefit received from such technology can also be evidenced by the increase in turnover and profits over the years during which such payments have been made.

4. Royalty payouts by Indian company in loss scenarios

The Indian Tax Authorities often question the need for royalty payment by Indian subsidiaries incurring losses as such licencing of technology has not resulted in any economic benefit. However the Delhi High Court, in the case of Commissioner Income Tax vs. EKL Appliances Limited has held that royalty payments cannot be prohibited on the premise of continuous loss if such payment can be proven to be incurred “wholly and exclusively” for the purpose of the business of the Taxpayer. The ruling emphasizes the importance of maintaining robust documentation that outline the business / commercial factors like start-up phase, market strategies, economic downturns, increase in competition due, new technologies, that have contributed to losses.

5. Ad-hoc disallowance for royalty under CUP Method

The Indian Tax Authorities in certain instances have made ad-hoc adjustments without adopting the prescribed methods to determine arm’s length royalty rate. In the case of Reebok India Co, the Delhi ITAT held that arm’s length price should be determined by one of the five methods and royalty rate determined by the Transfer Pricing officer without specifying any cogent basis is not sustainable.

Similarly in the case of Johnson & Johnson Ltd, the High Court of Bombay held that where no reason was given by TPO justifying restriction of technical know-how royalty paid by assessee to AE and ALP was not determined, such restriction being arbitrary was not sustainable.

INTERNATIONAL JURISPRUDENCE RELATING TO ADHOC ADJUSTMENTS

I. Poland vs “Fertilizer TM S.A.”

A Polish fertilizer manufacturer, “Fertilizer TM S.A.”, had transferred legal ownership of its trademarks to its subsidiary “B” and then paid substantial royalties for the use of the same trademarks. The tax authority considered B’s role to be merely “administrative” and recharacterised the licence agreement as a contract for trademark management services. On this basis, the tax deductions taken by “Fertilizer TM S.A.” were significantly reduced and an assessment of the resulting additional taxable income was issued. On appeal, the assessment was upheld by the Court of First Instance and the case was then brought before the Regional Administrative Court. In April 2022 the Regional Administrative Court concluded that, under the provisions of the Income Tax Act in force during the period under review (2013-2014), the tax authority could not lawfully disregard a valid licence agreement or replace it with another type of service agreement. On an appeal, The Supreme Administrative Court upheld the decision of the Regional Administrative Court and dismissed the appeal

II. South Africa vs ABD Limited

ABD Limited is a South African telecommunications company with subsidiaries worldwide. These subsidiaries are operating companies, with local shareholders, but having ABD as a significant shareholder. ABD licences its intellectual property to these operating companies (referred to as Opcos) in return for which they pay ABD a royalty. The present case involves the royalty payments made by fourteen of the Opcos to ABD during the periods 2009 to 2012. ABD charged all of them the same royalty rate of 1% for the right to use its intellectual property. In 2011 ABD retained the services of a consultancy to advise it on what royalty it should charge its various Opcos.The consultancy procured research on the subject and then, informed by that, came up with the recommendation that a royalty of 1% could be justified. The tax authorities (SARS) found that a 1% royalty rate was not at arms-length and issued an assessment where the royalty rate had instead been determined to be 3%. Judgment of the Court- The Court ruled in favour of ABD Limited and set aside the assessment.

Way Forward

In light of the changing digital landscape, it is important that the compensation for transactions involving intangibles is aligned with its value creation. The onus lies on the Taxpayers to maintain robust documentation which includes a comprehensive value chain analysis (DEMPE), agreements, royalty computation, comparability analysis and other relevant documents to be able to substantiate the arm’s length pricing of such transactions and minimise tax adjustments. Businesses may also consider Advance Pricing Agreements as an effective alternative to bring in tax certainty with respect to royalty transactions on congenial terms.

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