Feature

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Royalty payments and tax relief – how to keep the taxman happy in India

Since the abolition of royalty caps, there has been uncertainty as to how much Indian subsidiaries can pay their parent companies to license intellectual property. Two cases offer some useful guidance in this sensitive area

Success in today's competitive market depends on production quality, innovation, low costs and the right marketing strategies. Whether intellectual property lies in a well-known brand name or a new technology that gives a manufacturer an edge over its competitors, IP rights have gained unprecedented importance in the commercial arena. Entities that do not own the most coveted IP rights themselves can still benefit from them through licensing.

Subsidiaries of foreign companies have better access to IP rights owned by their parent companies and are often the chosen licensees. Indian subsidiaries of foreign conglomerates are no exception to this and, wherever possible, will gain advantage in the domestic market by licensing world-famous brands and newer technologies owned by their parent companies. The need to license is known and accepted in almost all sectors.

India's approach to royalties

The Indian government has recognised the need to introduce newer technology and to rationalise the manufacturing processes that come with the use of established brands. As part of the liberalisation of the Indian economy (which began in 1991), the government permitted the remittance of royalties for use of technologies and/or brands within prescribed limits and subject to certain conditions under the automatic route (ie, where prior government approval was not required). This scheme saw ongoing initiatives and further relaxation until 2009, when the government decided to remove all restrictions – including royalty payment caps. This move was welcomed by foreign investors, which could previously receive maximum royalties of only 8% for export sales and 5% for domestic sales in cases of technology transfers (with or without brand names), and 2% for export sales and 1% for domestic sales in cases involving brand names only.

Royalties under the new regime

The prescribed royalty caps, which were unpopular with foreign shareholders, did not always result in payments commensurate to the benefit that the Indian entity derived from the licence. After the caps were removed in 2009, several Indian subsidiaries reported a substantial jump in the royalty payments being made to their foreign shareholders. However, independent experts contended that such increases hurt the profitability of the Indian companies, diminished the chances of a healthier dividend roll-out to minority shareholders and resulted in a loss of taxes payable to the Indian exchequer. Reports even suggested that the Indian government was reconsidering the cap abolition.

Thankfully, the position remains unchanged. However, does this mean that under the current foreign direct investment policy, foreign shareholders/licensors have a free pass to impose exorbitantly high royalty rates on Indian subsidiaries with no checks or balances?

Royalty payments may be claimed by Indian subsidiaries/licensees as a permissible business deduction under the Income Tax Act 1961. These deductions may be made when the annual taxable profit is calculated, provided that they are wholly and exclusively incurred for business.

Defining 'wholly and exclusively'

The concept of an expenditure that is 'wholly and exclusively' laid out or expended for the purpose of trade was examined by Lord Brightman in the English case of *Mallalieu v Drummond*, in which a deduction of £564 was claimed by a female barrister for replacing, cleaning and laundering her court clothes. While the tax authorities argued against this deduction, the House of Lords found that while such expenses "are not wholly and exclusively laid out for the purpose of the trade, profession or vocation, they are laid out in part for the advantage and benefit of the taxpayer as a living human being". Since these "two purposes are inextricably intermingled and not severable by any apportionment that the court could undertake", the deduction was allowed.

The two unexpected inferences that may be drawn from this decision in respect of the permissibility of business deductions are that:

- the concept of 'necessity' for ascertaining the purpose of the payment was rejected; and
- where the court was unable to segregate an expense, it abstained from doing so.

Royalty as an allowable expenditure

The concepts of necessity and segregation were both examined by the Delhi Income Tax Appellate Tribunal (ITAT) in its recent decision in *Maruti Suzuki India Ltd* where, among other things, a purported royalty payment for the use of the brand name Suzuki was rejected by the transfer pricing officer and an appeal was brought by the assessee.

In the original assessment proceedings, the tax authorities sought to segregate a consolidated payment made by the Indian

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subsidiary to the foreign parent company for the use of technology and the brand name Suzuki, attributing a substantial portion of the consolidated payment towards the use of the brand name. The assessment observed, among other things, that: "Royalty for brand was paid to SMC, Japan, assessee itself was promoting the brand Suzuki which was a lesser known brand. That since the Suzuki brand was undoubtedly lesser known brand in India and has piggybacked the brand name Maruti which was an established brand there was no case for the assessee to have paid any brand royalty to SMC, Japan." The ITAT's intervention was sought on two questions:

- Can the authorities segregate consolidated payments and thus be permitted to rewrite the terms of commercial arrangements between parties?
- What is the role of necessity in permitting business deductions?

The ITAT opined as follows: "The TPO has re-written the agreement/transaction undertaken by the assessee by artificially segregating the single transaction of payment of royalty into two transactions of payment of royalty for use of brand name and for use of technology. We agree that such re-writing of transaction is inconsistent with the factual realities of the case and is also contrary to the various judicial pronouncements."

The ITAT rejected the argument of necessity of payments, relying on *Ekl Appliances,* in which the Delhi High Court observed, in favour of the licensee, that: "It is not necessary for the assessee to show that any legitimate expenditure incurred by him was also incurred out of necessity. It is also not necessary for the assessee to show that any expenditure incurred by him for the purpose of business carried on by him has actually resulted in profit or income either in the same year or in any of the subsequent years. The only condition is that the expenditure should have been incurred 'wholly and exclusively' for the purpose of business and nothing more."

Considerations weighing with the tax authorities

While the decision in *Maruti Suzuki* settled the position as to what is permissible when adjudicating transfer pricing issues with regard to royalty payments from an Indian subsidiary/licensee to its foreign shareholder/licensor, the question remains as to the grounds on which the authorities can reach such far-fetched conclusions (eg, in *Maruti Suzuki*, the authorities went on to comment on the alleged worthlessness of the parent company's brand).

The problem may stem from the fact that contractually, royalty payments are often linked to the Indian subsidiary's gross sales. However, when the tax authorities compare the total royalty payable against profit after tax, staggering numbers appear.

The tax authorities in India are also known to be sensitive towards cases where Indian subsidiaries/licensees suddenly start paying royalties to a foreign shareholder/licensor.

In fact, both of these considerations weighed with the tax authorities in *Nestlé India Ltd*, the appeal of which was decided by the ITAT in 2007. The tax authorities relied on the fact that post-liberalisation, Nestlé's revenue expenditure in the form of royalties had risen sharply. In assessment year 1992-93, royalties against profit after tax stood at 4.48%. This figure soared to 78.37% for assessment year 1997-98 and 49.95% for assessment year 1998-99. The authorities also questioned the relevance of these payments, insofar as they believed that Nestlé India already had access to its parent company's manufacturing facilities, as well as to various scientific R&D, and thus questioned the commercial justification for this sudden and dramatic increase in royalty payments.

As well as submitting documentation in support of these royalty payments, Nestlé India raised a valid point that profit depends on various factors outside the direct and reasonable control of the technical assistance provider, and thus the amount of remuneration cannot be linked to profit. It also contended that the percentage of royalty as against profit after tax was higher during the relevant assessment years because net profit as a percentage of turnover itself was lower. The ITAT accepted this argument, observing: "In the order of the authorities below, no material has been brought on record except disbelieving the assessee's explanation and their subjective opinions. The burden of their order is that the assessee so arranged its course of business that it was left with a less than ordinary profit expected in the assessee's line of business. No one, however, has taken care to specify as to how much that ordinary profit was supposed to be and on what basis the same could be determined… We, therefore, hold that the disallowance of the assessee's claim of deduction on account of remuneration paid for technical assistance is not called for in both the asst. yrs. 1997-98 and 1998-99. We direct accordingly."

The case is also pivotal because the ITAT accepted Nestlé India's argument that royalty payments fell within the prescribed cap. However, since these regulatory caps no longer exist, the reasonability and/or permissibility of royalties now depends solely on the tests prescribed by the revenue authorities.

The way forward

Now that caps on royalty payments have been removed, the attempts of Indian subsidiaries/licensees to claim deductions for royalties paid are solely at the discretion of the tax authorities, which may not only pass judgement on financial transactions concluded within a relevant assessment year, but also reopen all assessments within the preceding six years (eg, to examine income believed to have escaped assessment or been wrongly assessed).

From the precedents quoted above, relevant entities should consider the following precautions in order to avoid adverse scrutiny by the tax authorities:

- avoiding a sudden increase in royalty rates, unless there is demonstrable justification for this;
- deciding the rate at which royalties are payable after deploying any of the accepted methods for calculating arm's-length price (as set out in Indian tax law);
- since tax authorities are capable of being influenced by the amount of consolidated royalty payments (as recorded by the Indian subsidiary), ensuring where possible that the royalties payable for different IP rights are recorded under separate headings in order to avoid the entire royalty payment from being disallowed;
- maintaining consistency with royalty rates charged from other subsidiaries internationally; and
- for technologies sought to be developed (in the future), potentially entering into a cost-sharing agreement with the Indian subsidiary for collective R&D (as opposed to a conventional IP licence at a later date), depending on the facts of the case. Such an arrangement will guarantee that recurring payments are made to foreign shareholders without them having to be classed as royalties. At times, such an arrangement for collective R&D (providing joint ownership rights to the foreign shareholder and the Indian subsidiary) may also qualify for tax relief.

Conclusion

In a nutshell, royalty payments by a licensee resemble the story of the hen that laid a golden egg each day. The question to be answered is whether the foreign entities are content with an egg a day or whether they wish to have all the eggs at once? WTR

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