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Increasing payment of Royalty by Indian subsidiaries- Tax & Regulatory issues to be considered

- **Post the economic reforms in the year 1991, India has seen increase in the number of multinational groups investing in India. While the Multinational Groups have allowed their subsidiaries to make use of the technology, the Intellectual Property (IP) has been retained by Parent companies and usually the Indian subsidiaries are asked to make a payment in the form of a 'Royalty' levy**
- **The quantum or percentage of levy of 'Royalty' depends on the nature of the IP, usefulness of such IP to the subsidiary, global policies of the group for use of such IP etc.**
- **While payment of an amount as 'Royalty' is generally permitted as per the Indian Regulations, there are various issues such as SEBI Regulations for listed entities and Income Tax issues concerning Transfer Pricing (TP), which have to be considered while making payments of amount as 'Royalty' to foreign group companies.**

1. Tax Issues to be evaluated on making 'Royalty' payments

1.1. The Income Tax Act(the Act) contains an exhaustive definition of the term 'Royalty' which includes the transfer of all or any rights (including the grant¬ing of a licence) in respect of a patent, invention, model, design, secret formula or process or trademark, including licensing of computer software.

1.2. Payment of Royalty to foreign companies, requires withholding of taxes generally @ 20% (Plus surcharge & cess) as per the Act, however generally lower withholding tax rates are prescribed for Royalty payments under the Tax Treaties which India has entered into with various countries.

1.3. In addition to the above, care also has to be taken to ensure that payments are at 'Arm's Length Price' (ALP), while making payment to Associated Enterprises (AEs) as per the Indian Transfer Pricing Regulations (TP Regulations).

1.4. Some of the key concerns from a TP perspective while making Royalty payments are as follows:

2.4.1. Selection of appropriate method, to benchmark the payment.

2.4.2. Application of the 'Benefit test'

2.4.3. Use of regulatory guidelines as a benchmark, to justify the royalty rates

1.5. There are various methods prescribed under TP Regulations to benchmark international transaction, to determine the ALP on Royalty transaction. CUP method is a direct method which compares price charged under the controlled transaction with price charged under uncontrolled transaction as against the other methods (i.e TNMM, RPM and CPM) which analyse the entity's profit margin (gross margin or net margin) to benchmark the transactions at ALP.

1.6. Further, while applying CUP method in case of royalty paid for use of unique and valuable IPs or entity engaged in use of high value branded goods, it becomes difficult to find uncontrolled transaction with same nature of product and contractual terms or if there exists any fundamental difference in the product, use of CUP method may not be appropriate.[1]

1.7 When accurate comparable transactions are not available to benchmark payment of royalty, the entity may choose to apply TNMM method under aggregate approach on entity level to determine ALP of all international transaction including royalty, however we have seen this approach at times is not accepted by the Indian tax authorities who insist on adoption of CUP method to benchmark royalty payments.

1.8 In this regard reference may be made to the Bombay High Court ruling in the case of Cummins India Ltd.[2]. In this case, the Taxpayer had applied TNMM method to benchmark its international transaction including payment of Royalty to its AE, the TPO segregated the payment of Royalty transaction from other international transactions and used CUP method to determine the ALP on royalty payment to its AE. The High Court in its decision held that since the TPO has accepted TNMM method as most appropriate method for benchmarking the AE transactions, it was not open to TPO to carve out only royalty transaction to an entirely different method. Any deviation in applying the method shall disturb the mechanism and would distort the final results.

1.9 Additionally, reference may also be made to the decision of the Bangalore branch of the Income Tax Appellate Tribunal (ITAT), in the case of Toyota Kirloskar Motor (P.) Ltd.[3]. In this case the ITAT held that separate benchmarking of Royalty transaction is not required where the Taxpayer has used TNMM as a method and selected comparable companies, where the comparable's margin were computed after including royalty transaction.

2. Benefit test and payment of brand fees/ royalty

2.1. Entities are liable to pay brand fees/ royalty for use of the brand, trademark, however use of such brand may not immediately benefit the business and a brand may require time to be recognised in a new market. In certain cases, it has been observed that the tax authorities in India, have questioned the requirement to pay Royalty for the use of a brand which is owned by an AE.

2.2. In this regard reference maybe made to the decision of the Delhi bench of the ITAT, in the case of Goodyear India Ltd.[4], where the ITAT held that any interference by the Tax Authority in deciding the benefit received by the Taxpayer by use of the brand, shall be violating the provisions of the Act and applying the 'benefit test' is not within the jurisdiction of the Transfer Pricing Officer (TPO).

2.3. Since The TPO is solely responsible for determining whether the royalty payment complies with the arm's length principle (ALP), any loss incurred by the company should not be correlated with the economic benefit derived from the use of technology or know-how, as profit and loss are determined by market forces.

2.4. In this regard, reference is made to ruling of Delhi bench of ITAT, in the case of Bestexx MM India (P.) Ltd.[5], where the ITAT held that once a valid agreement exists for the transfer of non-exclusive rights to use the technology and know-how of the Associated Enterprise (AE) for manufacturing automotive parts, from which the assessee has earned significant revenue, the use of this technology and know-how is directly linked to manufacturing and sales. The incurrence of loss cannot be used as a basis to claim that the technology or license provided no benefit, and thus, there was no need to pay royalty.

2.5. Losses should not be connected to the economic benefit derived from the use of technology or know-how, as profit and loss are influenced by

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[1] Para 6.11 of GUIDANCE NOTE ON REPORT UNDER SECTION 92E OF THE INCOME-TAX ACT, 1961 (TRANSFER PRICING) - CUP Method compares the prices of the products, it is warranted that high degree of similarity on all aspects (such as products / services, terms of the transaction etc.) be established between the products being compared.

[2] Cummins India Ltd. Vs. Assistant Commissioner of Income-tax, [2023] 153 taxmann.com 223 (Bombay)

[3] Toyota Kirloskar Motor (P.) Ltd. Vs. Assistant Commissioner of Income-tax, LTU, [2024] 158 taxmann.com 79 (Bangalore - Trib.)

[4] Goodyear India Ltd. Vs. Deputy Commissioner of Income-tax, [2024] 165 taxmann.com 830 (Delhi - Trib.)

[5] Deputy Commissioner of Income-tax, Circle-4(2), New Delhi vs. Bestexx MM India (P.) Ltd. [2018] 92 taxmann.com 87 (Delhi - Trib.) [15-02-2018]

market dynamics and other economic factors. The Transfer Pricing Officer's (TPO) enquiry should ideally be restricted to ensuring that the Royalty payment is made at ALP and not whether there is a need to make the Royalty payment from a commercial perspective.

3. Application of SEBI regulations while benchmarking Royalty rate

3.1. As per the section 23(1A) of the SEBI (LODR) Regulations[6] , payment of brand fees or royalty to related party shall be considered material if the aggregate value of transaction exceeds 5% of annual consolidated turnover as per the last audited financial statements of the listed entity. Such material transaction requires approval of audit committee.

3.2. Till 2009, royalty was subject to approval from the Government if payments exceeded 5% of sales/8% of exports/USD 2 million. This was discontinued from 2009 onwards and as on date, we believe, there are no specified limits by the Government on Royalty payments. Further, royalty rate has generally been in excess of 2% of sales.[7]

3.3. Payment of Royalty by listed entities exceeding the thresholds would require approval of the audit committee to justify whether the quantum of Royalty payments is appropriate.

4. Concerns on Ad-hoc adjustment made by the Assessing officer or TPO on royalty payment

4.1. Where no comparable had been found in respect of royalty payment made by the Taxpayer to its AE, there are concerns raised by the TPO by limiting the payment of royalty by applying an ad-hoc percentage.

4.2. In this case reference may be made to the decision of the Bangalore bench of the ITAT in the case of Toyota Kirloskar Motors Private Ltd.[8], where the Royalty paid by the Taxpayer was restricted by the TPO to a particular percentage on an estimate which was held to be arbitrary in nature. Similarly, the Bombay High Court in the case of Johnson & Johnson Ltd.[9], held the TPO could not restrict the Royalty payments by applying an arbitrary basis. The TPO in this case was directed to delete the TP adjustment.

5. Concerns on companies paying high rate of royalty and projecting low profit margins

5.1. Generally, it is seen that when Multinational Groups set up subsidiary company in India, during the initial years of business, the subsidiary company shall have to depend on the holding company/ group company having substantial intangibles and well-known brands, to help it establish a robust market share in India.

5.2. When the subsidiary uses the 'brand' of the holding company, they enter into royalty agreement and undertake to pay Royalty at a minimal rate or in some cases royalty free agreements are entered into to allow the subsidiary companies to set up a sound financial base in India. However, as the subsidiaries become profitable in India, the rate of levy of Royalty is increased, which at times leads to subsidiary in India either earning minimal profits or going into losses post payment of royalty which is generally calculated on gross sales rather than on the profits of the company.

5.3. It has been observed that the Tax Authorities in India, question that whether payment of Royalty is required especially when the payment is used for usage of 'brand name' or technology which has been used for multiple years, hence it becomes critical to justify the need for making the payment of 'Royalty' and also to benchmark the percent or quantum which is paid as Royalty.

5.4. In this case, reference may be to the Delhi High Court's decision in the case of EKL Appliances Ltd , where the Taxpayer had a royalty agreement with its AE for use of know-how or brand, the TPO while computing ALP, held that the AE did not profit from the use of brand name since it continuously incurred losses and determined the ALP of Royalty transaction as NIL. The Delhi High Court held that the TPO has no authority to disallow the entire expenditure or a part thereof on the ground that the Taxpayer has suffered continuous losses.

6. Concluding Thoughts

6.1. The use of the IP and its benefits for the business in India, should be properly documented, so that the payment of 'Royalty' can be justified if questioned by the authorities.

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[6] *SECURITIES AND EXCHANGE BOARD OF INDIA (LISTING OBLIGATIONS AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2015*

[7] *Amendments to SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015- payments relating to royalty and brand usage and*

[8] *[TS-650-ITAT-2016(BANG)-TP]*

[9] *Commissioner of Income-tax Vs. Johnson & Johnson Ltd. HC, [2017] 80 taxmann.com 337 (Bombay)*

6.2. Benchmarking of the transaction is a critical aspect to justify that the payments are at ALP, failure of which shall led to TP adjustments. This aspect is extremely critical when the payments are made for IPs which are unique in nature (i.e. for instance for the use of technology, which other companies do not possess) or when the payments are made for the usage of brand name or trademarks.

6.3. A company has to carefully evaluate the method which is being used to justify the ALP under Transfer Pricing Regulations, while generally the CUP method is used, TNMM can also be applied where adequate comparable transactions are not available, or the IP used is of such nature which cannot be benchmarked appropriately.

6.4. Additionally, the terms of 'Royalty' payments have to be regularly monitored to ensure that the payments are not deemed to be excessive in nature, especially when companies are not making profits in India or where companies do not have adequate profit margins, which can sustain consistent payments of Royalty.

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