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September



# Intellectual Property Rights – Key India Tax & Regulatory nuances in transactions and other business arrangements



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The tax regime in India applicable to taxation of intellectual property rights (IPR) has seen significant developments in the past few years – be it the retrospective amendment to the definition of ‘royalty’ under the Income-tax Act, 1961 (IT Act), the introduction of the patent box regime, or the landmark decision in Engineering Analysis<sup>2</sup> case regarding the long-drawn software taxation issue.

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1. The views of the author(s) in this article are personal and do not constitute legal / professional advice of Khaitan & Co.

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2. [2021] 125 taxmann.com 42 (SC)

From a practical perspective, there could be several IPR related tax nuances in M&A deals involving businesses where IP is one of the key value drivers. These would typically include aspects such as situs and valuation of IP, availability of depreciation on IPR / goodwill which impacts the effective tax outgo requiring attention in the initial stages of a deal, how the IP has been valued and recorded in any intra-group service arrangements. Additionally, in cross border service arrangements, the service recipient's versus service provider's ownership rights in IPR generated in the course of services, and related issues with respect to assignment of IPR in favour of the service recipient, also become critical for tax and regulatory purposes.

In this article, the authors discuss certain key aspects in relation to taxation and regulatory regime in India which are relevant to businesses having IP as one of the important assets of business.

## 1. BACKGROUND

### 1.1. Royalty – IT Act versus tax treaties

1.1.1. With respect to taxation of income arising to non-residents from exploitation or licensing of intangibles, the first aspect that is noteworthy is the manner in which "royalty" has been defined and consequent application of source rules. Under the IT Act, the definition is comprehensive and includes the consideration payable for the transfer or use of a variety of IP rights – such as trademarks, copyrights, patents, secret formula, design, literary work, computer software etc. It also covers the rendering of any services in connection with the activities that are referred to in the definition clause. The definition read

with the source rules determine taxation of non-residents earning income from India from sale or exploitation of IPRs.

1.1.2. Under the IT Act, non-residents are taxable in India on all India sourced income defined in the source rules as income which accrues or arises in India, or income which is deemed to accrue or arise in India. This determination regarding chargeability to tax is not only relevant for the recipient of income but also for the payer. This is because under the IT Act, any person making any payment to a non-resident which is taxable in India, is required to withhold the applicable tax at source. Additionally, in case of non-residents, tax treaty analysis is as important as the analysis of the provisions of the IT Act. This is because the provisions of the IT Act or the applicable tax treaty, whichever are more beneficial, shall apply when determining taxes payable by a non-resident in India.

1.1.3. In terms of deeming source rules, in case of royalty payable to a non-resident, if the payer is an Indian tax resident, then, the same is generally taxable in the hands of the non-resident recipient in India in all cases except where the royalty is payable in respect of any right, property etc used for any business or profession carried on outside India or for earning any income outside India. On the other hand, for the royalty payable by one non-resident to another, then, the same would be taxable in India only where the royalty is payable in respect of any right, property etc used for any business or profession carried on in India or for earning any India source income.

1.1.4. One issue which had been the subject matter of constant litigation in relation to



royalty characterisation was about computer softwares, where non-residents sold or distributed computer software in the Indian market. Generally, the taxpayers took the view that income from such transactions would be subject to the generally applicable business profits' related taxation thresholds (ie no Indian income-tax trigger unless there is a taxable presence in India). On the contrary, the tax authorities alleged that such consideration would qualify as consideration for transfer of rights in respect of copyright and hence, taxable as royalty. This resulted in a series of long-drawn litigation battles between the non-resident taxpayers and Indian income-tax authorities.

1.1.5. Notably, the definition of 'royalty' underwent some important amendments in the year 2012 (applicable with retrospective effect from 1976) whereby it was inter alia clarified that transfer of all or any rights in relation to computer software was always included within the ambit of royalty, regardless of the medium through which the software is transferred. Its impact was twofold – one, the consideration for use of computer software was clearly categorised as royalty under the IT Act, and two, the factor of medium of transfer was clarified to be immaterial for this assessment. This amendment, instead of settling the debate, created more uncertainty especially given the different scope of "royalty" as defined under the IT Act and the bilateral tax treaties, and hence led to litigations between the taxpayers and tax authorities in relation to interpretation of 'royalty'.

## 1.2. Royalty – Tax treaties

1.2.1. The main reason that led to the continuance of tax litigation on this account was the difference in scope of the definition of royalty under the IT Act and the tax treaties – while the definition under the domestic tax law stood expanded, the scope of taxation under the bilateral tax treaties continued to remain unchanged which had a relatively narrower scope. The core issue with respect to computer software was whether it would fall within the ambit of a copyrighted article or a copyright itself.

1.2.2. Under tax treaties, income from use of a copyright is generally treated as "royalty" and unlike the IT Act, payments for sale and purchase or transfer of rights in computer software are not deemed as "royalty"<sup>3</sup>. Accordingly, income from sale of software would generally be treated as transfer of a copyrighted article under tax treaties, which, like sale of any other goods or products, should be governed by the principles applicable to taxability of business income ie would be taxable in the source jurisdiction only if the non-resident has a permanent establishment therein.

## 1.3. Supreme Court judgment in the case of Engineering Analysis Centre of Excellence Private Limited

1.3.1. This was a landmark judgment in the context of software taxation in India as it settled a nearly 20-year-old dispute wherein the income-tax authorities, in several cases across the country, had taken the position that

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3. Certain tax treaties such as India's tax treaties with Romania and Russia specifically cover computer software programme within the ambit of royalty and therefore, specific provisions of the applicable tax treaty would be relevant in specific cases.

payments to non-residents towards software program / license constituted 'royalty' under the IT Act as well as the relevant tax treaty. This position was taken on the basis that such arrangements constituted transfer of 'copyright' in the software (whether purchased by end-users or resellers). Accordingly, as the IT Act casts a withholding obligation in respect of all payments to non-residents which are taxable in India, the tax authorities considered the resident payers (who did not withhold tax on such payments) as 'assessee-in-default'.

1.3.2. There were divergent judicial views with respect to this issue inasmuch as on one hand, the above position taken by the tax authorities was affirmed by Hon'ble Karnataka High Court in multiple rulings and also by the Authority for Advance Rulings in one ruling; and on the other hand, Hon'ble Delhi High Court and Income-tax Appellate Tribunal benches in several cases affirmed the taxpayers' position that payments for software program / license constituted payment for a 'copyrighted article' and not payment for 'copyright', and hence were not chargeable to tax as 'royalty' income in the hands of the non-resident supplier. Appeals from these matters travelled to the Hon'ble Supreme Court, with appeals filed by both, the taxpayers as well as the income-tax department.

1.3.3. Hon'ble Supreme Court held that payments for computer software to non-resident suppliers, by end-users or distributors resident in India, do not constitute 'royalty' under the relevant tax treaties<sup>4</sup> entered by

India. Accordingly, the Court held that such payments do not give rise to any income taxable in India in the hands of foreign suppliers and consequently, there was no obligation on Indian resident payers to withhold tax under the IT Act.

1.3.4. In addition to bringing an end to a long-disputed issue, this judgment laid down / upheld several principles that will occupy a significant position in India's international tax jurisprudence – for instance, the Supreme Court recognized the impossibility to withhold tax, in respect of retroactive amendments that expand the scope of what was taxable (prior to the amendment). Further, besides holding that the OECD commentary has a 'persuasive' value, the Supreme Court also held that taxpayers can place reliance on the OECD commentary vis-à-vis OECD model tax convention provisions which are used without any substantial change in India's tax treaties, in the absence of judgments clarifying the same or in case of conflicting court decisions.

1.4. In the context of taxation of royalty earned by non-residents from India, tax treaty analysis would be relevant not only from the perspective of the scope of the definition of royalty under the applicable tax treaty but also from the perspective of the applicable tax rate. The tax treaties generally cap the withholding tax rate on royalty income at 10% / 15%. The effective tax rate under the IT Act with respect to royalty earned by non-residents can go upto 11% (10% plus applicable surcharge, cess). Therefore, if the applicable tax treaty caps

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4. In this judgment, a total of 18 tax treaties entered by India were relevant to the batch of appeals before the Supreme Court



the withholding tax rate at 10%, and the non-resident taxpayer is eligible to treaty benefits, there may be some tax savings.

### 1.5. Patent box regime

1.5.1. In the past several years, India has experienced increased capabilities of innovative, creative and capable young professionals for creation of significant and valuable IP. At the same time, it was also seen that instances of IP ownership residing offshore were not uncommon. While there are several 'non-tax' reasons for this loss of ownership in favour of other jurisdictions, the absence of any concessional tax regime remained one of the major reasons. [Some notable jurisdictions which are favoured by IP owners are: Ireland, Netherlands, Switzerland, Singapore.]

1.5.2. Hence, in order to encourage indigenous research & development (R&D) activities and to make India a global R&D hub, a concessional taxation regime for income from patents was introduced in 2016, so as to (i) provide an additional incentive for companies to retain and commercialise existing patents and to develop new innovative patented products, and (ii) encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

1.5.3. This was implemented by way of insertion of a new section (115BBF) in the IT Act to tax the income of any eligible taxpayer derived from royalties at the rate of 10% on a gross basis (colloquially referred to as the patent box regime). Notably, income which is taxed as per this concessional regime is exempt from Minimum Alternate Tax (MAT). A taxpayer who is resident in India and is the 'true

*and first inventor*' of the patent registered under the Patents Act, 1970 for the use of which it is receiving royalties is treated as eligible for this concessional regime. This was in line with the 'nexus approach' under Action 5 of the BEPS recommendations, which confers the right to tax on that jurisdiction, where substantial R&D activities are carried out.

### 1.6. Depreciation on goodwill

1.6.1. Recording of goodwill in the books of accounts pursuant to acquisition or reorganisation of business (especially in case of business transfers under a tax neutral corporate restructuring scheme) and claim of depreciation on it has been a long-debated issue under the IT Act. IT Act provides for depreciation on various intangible assets (which were defined as know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature) which are used and owned for the purpose of business. Despite goodwill not being mentioned in the list of intangible assets, courts had held that goodwill will qualify as an intangible asset as it will fall under the expression '*any other business or commercial right of a similar nature*' by applying the principle of *ejusdem generis*.

1.6.2. Vide Finance Act 2021, '*goodwill of a business or profession*' was expressly excluded from the definition of intangible assets making it a non-depreciable asset. This amendment can have far-reaching consequences and implications for M&As and corporate restructurings, especially from a valuation perspective. Though this was a prospective amendment, its impact on past transactions should also be evaluated. Notably, this amendment talks about 'goodwill' only, ie other intangible assets and other business/

commercial rights continue to remain depreciable under the IT Act.

With this background, some other practical considerations and implications with respect to taxation of IPRs in India are discussed below.

## **2. IP LICENSING ARRANGEMENTS**

2.1. In case of IP licensing arrangements where a foreign entity licenses its brand or other IPR to an Indian entity, depending on the terms of the licensing arrangement (as briefly discussed below), certain Indian tax considerations become relevant.

2.2. In order to protect the brand / IPRs, the licensors typically include strong covenants in the agreements restricting the licensee from taking certain actions or enabling the licensee to take certain actions only after being approved by the licensor. While having such covenants is important from a commercial perspective, the extent of control or involvement of the licensor could expose the licensor to a taxable presence risk in India. This is because if the foreign entity is seen as participating in the operational matters of the Indian licensee, the licensee could be viewed as an extension or a taxable presence of the licensor in India. Therefore, a careful review of the contractual package at the initial stages of entering into a binding agreement becomes important so as to identify and distinguish protective rights from those of participative rights.

2.3. Resultantly, the documentation and contractual terms are extremely important in such type of commercial arrangements so that there are no unintended tax consequences for either party.

2.4. Additionally, from the perspective of Indian transfer pricing regulations, if the business of one enterprise wholly depends on the use of IPRs owned by the other enterprise, then such enterprises are deemed as related parties, requiring transactions inter se them to be subject to the arm's length test and compliance and documentation requirements. Therefore, even if the entities are otherwise unrelated, transfer pricing provisions could apply.

## **3. TRANSFER OF IP FROM OUTSIDE INDIA**

3.1. In the context of IP ownership and IP transfer, transfer of IP from outside India is also a complex issue, primarily for non-tax reasons. This is because the characterisation of assignment (as opposed to a license) of an IP right from non-resident to resident as a capital account transaction or a current account transaction is subject to different interpretations and views. Similarly, whether RBI approval is required or not for such a transaction is also not free from doubt. At a time when Indian economy and the inbuilt entrepreneurial spirit are rapidly growing, having clarity regarding the interpretation of this aspect is essential. A similar analysis would be relevant for IP transfers from a resident to non-resident also and hence, a careful review of the transaction structure should be undertaken in such matters.

3.2. Though primarily this is a regulatory issue, depending on the regulatory conclusion, its analysis from income-tax perspective also becomes significant. This is because if it is regarded as akin to a transfer, then the resultant gains would be subject to capital gains taxation provisions as against a normal right to use wherein the income would be



taxed as royalty in the hands of the recipient. From non-resident's perspective, this assumes significance especially from treaty perspective because the nature of relief in a capital gains article under tax treaties would be different than that in a royalty article therein.

3.3. Notably, this would be relevant from a withholding tax perspective also accordingly and hence, becomes a real-time issue at the time of undertaking a transaction itself, and not just at the time of filing income-tax return by non-resident.

#### **4. CREATION AND OWNERSHIP OF IP IN THE COURSE OF SERVICES PROVIDED BY AN INDIAN ENTITY**

4.1. India is a large market for software development and related services where the services are typically rendered by Indian entities employing the manpower and resultant IP is owned by their offshore parent / affiliate / service recipient. A typical cross border arrangement in this space would involve a foreign group setting up an Indian entity (which employs the human capital locally) for rendering specified services to the offshore parent on a cost-plus mark-up basis. Essentially, the execution work is carried out by the India entity wholly for the parent, whereas the parent would have third party customers and may be involved in strategic, planning, development activities outside of India. Typically, ownership of IP which is generated in the course of such services provided by the India entity vests or is intended to be vested with the offshore parent / affiliate. Further, in terms of risks undertaken, generally, the Indian entity is a low-risk entity.

4.2. From an income-tax perspective, what is essential to take into account in such structures is that the benchmarking analysis of the intra-group transactions is consistent with the commercial realities of the arrangement and adequately covers the functional, assets and risk analysis. This becomes important especially in a scenario where the tax authorities wish to scrutinise and assess whether the Indian arm is being compensated adequately on an arm's length basis for the work undertaken by it.

4.3. In structures where the offshore parent does not have local teams or substance, it may be difficult to defend any value add at the offshore level in which case the tax authorities may allocate higher or most of the value or group revenues to the India entity instead of accepting merely a cost-plus markup. This could lead to transfer pricing adjustment in the hands of the Indian entity and increase the base on which it will need to pay income-tax in India. The effect of such transfer pricing adjustment(s) could get further enhanced on account of the fact that Indian transfer pricing regulations contain 'secondary adjustment' provisions also, which basically require the Indian taxpayer entity to ensure that such amount which are the subject matter of a transfer pricing adjustment is repatriated back to India failing which it will be regarded as a deemed advance to the offshore related party subject to interest imputation in the hands of Indian party. Therefore, a holistic review of facts is important for identifying and mitigating any tax risks especially in M&A deals to ensure that a buyer buying a target having such arrangements is aware of the risks while negotiating indemnity package and takes mitigation / correction steps post-closing.



4.4. Further, in such arrangements, the aspect of IP ownership is also critical because of the *work for hire* concept in some countries, which basically means that IP ownership would vest in the offshore entity (and not with the local creator) from commencement itself. Whereas under Indian laws, technically, the IP that gets developed at the India level may be owned by the IP developer locally at the India level at commencement / creation stage (in the absence of specific clauses on assignment of IP to offshore entity) regardless of the commercial understanding that the IP ownership should always vest with the foreign entity. What this means is that the language of the IP related clause in the service agreement needs to be carefully worded and drafted so as to reflect the real commercial understanding between the parties without triggering any unintended tax consequences for either party. This is because unless appropriately drafted, the tax authorities may allege that an IP transfer takes place after it has got developed by the Indian entity locally. This also needs to be balanced from an Indian IP laws perspective since without a specific language on assignment of IP to offshore entity, the IP may continue to vest with the IP developer under Indian IP laws.

## 5. SITUS OF INTANGIBLES

5.1. Unlike tangible assets (whose situs is easily determinable), in the absence of any specific rules, identification of the situs of an intangible asset can be complex. This is because in the case of IPRs, value creation and accretion can happen in multiple jurisdictions for various reasons – for instance,

the location of IPR registration (on account of pragmatic IP laws) or the location where maximum customers are located (on account of economic presence) etc. From income-tax perspective, this creates difficulty in applying the nexus rule for taxing capital gains at the time of IP transfer because under the IT Act, gains derived from the transfer of a capital asset situated in India are taxable in India.

5.2. This issue was dealt with in the landmark case of *CUB Pty Ltd. vs. UOI [2016] 71 taxmann.com 315 (Delhi)* wherein the Hon'ble Delhi High Court held that the income arising from transfer of IPRs, in particular, brands, trademarks and logos, is not taxable in India if the ownership of the IPRs is outside India – to arrive at this conclusion, the Hon'ble Court held that the situs of the owner of an intangible asset would be the closest approximation of the situs of an intangible asset (basis the well-established principle of *mobilia sequuntur personam*<sup>5</sup>) as no deeming fiction with respect to location of intangible assets has been made by the Legislature. Notably, to allege that the situs of such IPRs was in India, the tax authorities had contended inter alia that the IPRs had generated appreciable goodwill in the Indian market and that the IPRs had gained from their Indian operations. This was a welcome ruling in one of the first cases dealing with situs of IPRs in the Indian context. That said, given the stand taken by the tax authorities that the IPRs could be considered as an asset located in India based on the fact that the IPRs attained value in India over a period of time, one could assume this to be an area of potential litigation and

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5. As per this principle, personal property held by a person is governed by the same law that governs that person.



undertaking a tax analysis and risk assessment in such transactions is therefore advisable. Revenue has challenged this judgment before the Hon'ble Supreme Court of India, which is pending.

## 6. CONCLUSION

6.1. With the present-day business models and digital businesses growing in value and reach, technology, knowhow and brands are more valuable than ever. This also means that laws would need to catch up with commercial realities and at the same time, jurisdictions where most value is created or exploited would want to protect their tax base and would not compromise it in favour of jurisdictions

where IP asset is merely held or owned by a local entity. For businesses and buyers looking at potential targets having IP as the key asset, one should pay closer attention to contractual documentation to achieve commercial objectives in the most tax efficient and legally compliant manner and avoid any unintended consequences. For buyers, a closer review during a due diligence exercise on the target, and while negotiating representations, warranties and indemnities from the seller, would be important. Moreover, consequences (if any) under other Indian laws (especially due to the peculiarities under Indian IP laws) should also be considered so as to have a holistic coverage of a transaction.

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## **The Chamber of Tax Consultants**

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The Chamber of Tax Consultants (The Chamber) shall be a powerhouse of knowledge in the field of fiscal laws in the global economy.

The Chamber shall contribute to the development of law and the profession through research, analysis and dissemination of knowledge.

The Chamber shall be a voice which is heard and recognised by all Government and Regulatory agencies through effective representations.

The Chamber shall be pre-eminent in laying down and upholding, among the professionals, the tradition of excellence in service, principled conduct and social responsibility.





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