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Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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India

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1. Does your country have a Patent Box regime (or a functionally equivalent preferential IP regime) or is a proposal for one under consideration?

- What benefits does it offer (e.g., partial exemption or reduced tax rate)?

- What are the terms of the regime (e.g., definition of intangible property, definition of intangible income, definition of qualifying expenditures, treatment of R&D outsourcing, treatment of acquired IP or acquisition costs, grandfathering provisions for expiring regimes, administrative/ compliance requirements, etc.)?

Our Response:

India has a concessional tax regime in respect of income from patents. Under the regime, royalty income earned by an eligible resident taxpayer from exploitation of patents developed and registered in India would be taxed at a lower rate of 10% as compared to the general corporate tax rate of 30% (increased by applicable surcharge and cess) on a gross basis without allowing deduction for any expenditure incurred in respect thereof [section 115BBF of the Income-tax Act, 1961 (the "Act")]. India also has an alternate code of income computation called Minimum Alternate Tax ("MAT"), applicable to companies, which considers book profit to determine the tax liability after making certain prescribed adjustments. Specific provision has been made to exclude such eligible royalty income from the levy of MAT.

Indian patent regime covers only royalties earned from patents registered and developed in India. Any gains arising from alienation of the patent or embedded royalties (i.e. notional royalties forming part of price of patented products) are not eligible for the concessional regime. Indian patents law does not grant patents for computer software and intellectual property rights ("IPRs") such as copyrights, trademarks, brand names, designs, know-how etc. which are not eligible for concessional tax regime. With respect to the condition of the patent being developed and registered in India, it has been mentioned that at least 75% of the total expenditure by the eligible taxpayer should be incurred in India. Accordingly, any expenditure directly or indirectly relatable to the invention / patent can be considered for a threshold of 75%. The expenditure incurred towards outsourcing of R&D activity may also be considered for a threshold of 75%. However, in the case of outsourcing of R&D, while there is no express provision in the patent regime prohibiting outsourcing, the patents law in India state that the provider of capital cannot be regarded as the true and first inventor eligible for registration of patent unless it can be demonstrated that he has contributed his knowledge, skills, ingenuity towards the invention.

The royalty income, which may be eligible for the concessional tax rate, arises only in respect of patents registered in India. The grant of a patent is a territorial right. The income from exploitation of patents obtained and registered in other countries may not be eligible for the concessional tax rate.

It may be noted that the patent regime is optional and a taxpayer can opt for it by furnishing the prescribed form[1] on or before the due date of the filing of the return of income for the relevant financial year. Once opted for, the tax liability has to be computed in accordance with this regime for five consecutive years, succeeding the year in which that option has been exercised, failing which, the taxpayer would not be eligible to claim benefit under this provision for five consecutive years from the end of the year in which that condition has been violated.

As there was no erstwhile patent box like regime in India, the question of grandfathering provisions for expiring regimes does not arise.

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2. Assume that a Country A parent company owns an IP affiliate eligible for the patent box regime in Country B. What Country A issues arise from this situation (e.g., CFC legislation, taxation of dividends from the patent box, etc.) ?

Our Response:

It is assumed that the parent company in Country A has set up an IP affiliate in Country B to claim benefits of the favourable IP regime in that country.

India does not have formal Controlled Foreign Company (CFC) regulations in force, it has a Place of Effective Management ("PoEM") test to determine the residential status of a company.

PoEM is defined as a *place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance, made*[2]. For the benefit of the taxpayers as well as the tax administration, the Central Board of Direct Taxes ("CBDT") has issued a set of guiding principles[3] ("PoEM Guidelines") to be followed in the determination of PoEM.

As per the PoEM Guidelines, PoEM shall be determined depending on whether the foreign company is an active company or a passive company. A company is said to be engaged in active business outside India if**:**

- Passive income is not more than 50% of its total income; and
- Less than 50% of its total assets are situated in Indiaand
- Less than 50% of total number of employees are situated in India or are resident in Indiaand
- Payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Passive income is defined as the aggregate of:

(i) Income from transactions where both the purchase and sale of goods is from / to its associated enterprises ("AEs"); and

(ii) Income by way of royalty, dividend, capital gains, interest or rental income. However, any interest income earned by a banking company / public financial institutions shall not be considered as passive income.

If the above conditions are not satisfied, the company shall be considered to be passive and its PoEM shall be determined after identifying persons who actually make the key management and commercial decisions for the conduct of company's business as a whole and the place where those decisions are made.

In the present case, as Company B is given to be an IP affiliate and would, presumably, have royalty and capital gains from the sale of IP as its main source of income, it is more likely that it would qualify as a company earning passive income under the PoEM Guidelines. Accordingly, its PoEM may be held to be situated in India if all the key management and commercial decisions are taken by Company A in India. Once the PoEM is adjudged to be in India, then Company B shall be regarded as resident in India and all the consequences thereof shall follow. One of the major consequences is that the worldwide income of such company would be charged to tax in India. If Company B is considered to be resident in India and has patents developed and registered in India then it will be eligible for concessional tax regime with respect royalty income from these patents.

There are no special rules for taxation of inbound dividends from Patent Box company and this shall continue to be governed by the general provisions of the Indian income tax laws.

Irrespective of whether the PoEM of Company B is in India or not, implications with respect to the taxation of dividends shall remain the same.

Indian tax laws provide for a concessionary tax rate @ 15% (as increased by applicable surcharge and cess) in respect of dividends received by an Indian company from a foreign company in which it holds at least 26% of the equity share capital. Despite company B being resident in India, it still remains a foreign company and hence, dividends received therefrom shall continue to be eligible for the beneficial tax rate of 15%.

3. Assume that a parent company owns an operating subsidiary in Country A and an IP affiliate eligible for the patent box regime in Country B. What are the Country A issues if royalties (or other payments) are paid from Country A to the IP affiliate in Country B? What is the impact if the IP affiliate does not meet the OECD modified nexus approach?

Primarily, royalty[4] or other payments made by an Indian payer to overseas payee are subject to withholding taxes in India. These payments would be subject to taxes being withheld by the payer in India, either under the domestic law[5] or as per the income tax treaties, whichever is beneficial. In order for the payee to be able to avail the benefit of treaty tax rate, it would be required to furnish its Permanent Account Number (PAN – tax registration) in India or fulfill the prescribed conditions[6], failing which a higher tax rate at the rate of 20% would be applicable. As the royalty income earned by the payee would be chargeable to tax in India, there would be return filing[7] and transfer pricing reporting[8] requirements to be complied by the payee in India. For the payer, the royalties will typically be available as deductible expense for tax purposes if withholding tax obligations have been complied with.

As per the Indian transfer pricing regulations, the royalties charged for the use of intangible property should meet the arm's length principle. Practically, the royalty payments in India are benchmarked using available external databases which are repositories of royalty agreements; and if necessary, corroborated by residual profit split method. All the above provisions are applicable irrespective of the fact whether the payee is eligible for the patent box regime in its country and whether or not it meets the OECD modified nexus approach.

Further, with regards to payee not meeting the OECD modified nexus approach, there are no specific provisions in the Indian tax law restricting the application of treaty rates, but it requires fulfillment of the anti-abuse tests. The anti-abuse test in a treaty scenario requires the payee to be the 'beneficial owner' of the royalties and meet the Principal Purposes Test (PPT)[9] . Even under the Indian domestic law, in line with Action 6[10] of the BEPS Project, general anti-avoidance rule (GAAR)[11] has been introduced in the tax law which provides power to the tax officials to treat any transaction or any arrangement as an 'impermissible avoidance arrangement', where the main purpose of entering in such transaction or arrangement is to obtain tax benefit. GAAR provisions may thus be triggered in case where the payee lacks economic substance and the main purpose of transaction is to obtain preferential tax benefit. While PPT and GAAR have their own trigger elements, the concepts and principles of 'modified nexus approach' when applied in case of a payee, yielding a negative outcome, could act as additional triggers for assessment under these anti-abuse tests.

It is interesting to observe that other than adhering to the arm's length price and withholding appropriate taxes, payer has limited role to play in the scheme of things while the obligation to substantiate lies mostly with the payee.

4. What other R&D tax incentives or benefits does your country offer to attract investment in R&D, e.g., credits, super-deductions, grants, tax holidays, etc.?

- **What are the requirements to be eligible for this tax relief (e.g., revenue thresholds, definition of intangible property, definition of qualifying expenditures, treatment of R&D outsourcing, treatment of acquired IP or acquisition costs, carry-overs, administrative/compliance requirements, etc.)?**

- **Can these incentives be combined with benefits received from a patent box regime (if available) or other incentives?**

There are various incentives provided under the Act to promote scientific research and development in India. Primary among them is the provision of a weighted deduction of 150% of the *expenditure incurred on scientific research (not being expenditure on land & building)* on in-house facilities, available to companies engaged in the business of biotechnology or manufacture of articles or things (except those specified in the Eleventh Schedule of the Act like beer, wine, other alcoholic spirits, tobacco, etc.). Such a facility has to be approved by the Department of Scientific and Industrial Research (DSIR). [Section 35 (2AB) of the Act]

A point to note is that deduction under the section is not linked to research leading to the development of intangible assets. Any systematic investigation based on science into the study of any materials and sources towards increasing the sum of knowledge, is scientific research. It is not necessary that a new product or thing is produced from doing scientific research. Often in the field of research and invention, the efforts undertaken may or may not yield fruitful results. The condition is whether any scientific research was undertaken or not, during the year. Whether such scientific research resulted in the ultimate aim for which that research was undertaken or not, is not a compelling condition to grant a deduction under section 35. The purpose of the Legislature in granting a deduction is for scientific research and not necessarily only for successful scientific research. However, the weighted deduction is being phased out. From 1 April 2020 only 100% of expenditure will be allowed.

100% deduction in respect of any expenditure (other than capital expenditure) incurred on scientific research related to the business is eligible for deduction under section 35(1)(i) of the Act. Also, expenditure incurred before the commencement of business, such as salary to an employee who engaged in research or purchase of raw materials for research, will be allowed as a deduction in the year of commencement of business subject to such amount approved by Director General (Income-tax Exemptions) in concurrence with the Secretary, Department of Scientific and Industrial Research, Government of India.

100% deduction in respect to capital expenditure on scientific research in respect of any expenditure incurred on scientific research related to the business is eligible for deduction under section 35(1)(iv) of the Act. Any expenditure of capital nature which is incurred three years immediately preceding the year in which the business is commenced will be allowed as a deduction in the year of commencement of business. Also, no depreciation will be allowed under section 32, on such capital expenses.

The Act has not provided any specific treatment of R&D outsourcing. Weighted deduction of the expenses incurred in relation to contract R&D cannot be claimed as this is not an in-house facility. Such expenses can be claimed under 35(1)(i) if the scientific research outsourced is related to the business of the assessee company.

The concessionary tax regime in respect of royalty income on patents specifically states that no deduction shall be allowed against royalty income and the concessionary tax rate is applicable on a gross basis. Hence, the benefit of concessional tax regime and R&D incentive cannot be claimed simultaneously. Practically, the expenditure on R&D will precede and lead to registration of a patent, whereas the benefit of the concession tax regime would start once the patent is registered, so it is possible to claim the benefit under both schemes.

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NOTES

[1] Form No. 3CFA
[2] Refer to section 6(3) of the Income-tax Act, 1961 as amended by Finance Act, 2016
[3] CBDT Circular No. 6 of 2017 dated 24.07.2017
[4] Ambit of royalty income under section 9(1)(vi) of the Income-tax Act, 1961
[5] Section 195 of the Income-tax Act, 1961
[6] The non-resident deductee shall be required to furnish following details and documents: 1) Name, e-mail id, contact number; 2) Address in the country of residence; 3) Tax Residency Certificate if the law of country of residence provides for such certificate; and 4) Tax Identification Number (TIN) in the country of residence. Where TIN is not available, a unique identification number is required to be furnished through which the deductee is identified in the country of residence
[7] Section 139(1) of the Income-tax Act, 1961
[8] Section 92E of the Income-tax Act, 1961
[9] PPT rule seeks to deny treaty benefits if one of the principal purposes of the arrangement or transaction was to obtain treaty benefits. India, amongst other countries, has signed the OECD's Multilateral Instrument (MLI) and has chosen to supplement the provisions of the PPT with a simplified LOB (S-LOB) test across all its Notified Treaties. While the PPT is applicable irrespective of the position adopted by other countries, S-LOB will be applicable when the treaty partners have chosen to apply it.
[10] Preventing the granting of treaty benefits inappropriate circumstances

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[11] Section 95 to 102 of the Income-tax Act, 1961