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Taxing royalty payments in a digital world: Keeping up with the changes in India

The Dbriefs India Spotlight series

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7 May 2019

Agenda

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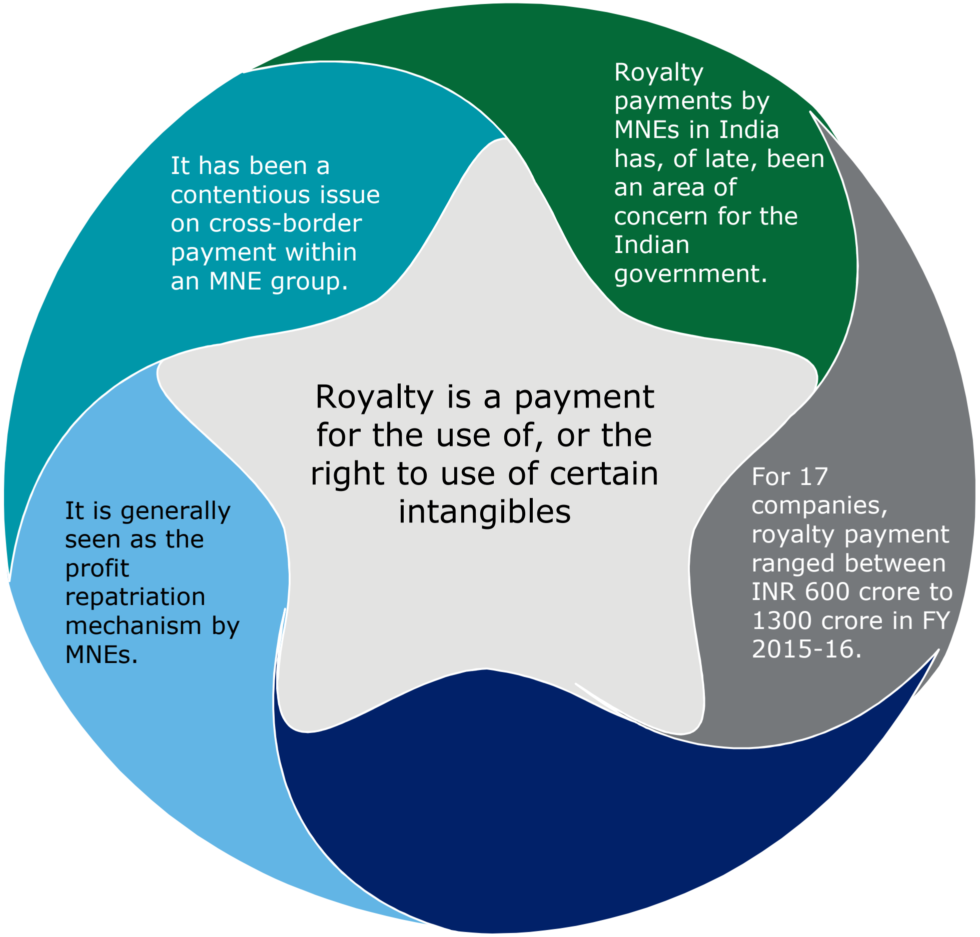
- Traditional royalty models
- Litigation and APA experience
- Digital economy – what has transformed
- Case studies
- How to determine royalty payout
- Unilateral actions on digital economy
- Questions and answers

Introduction

Royalty pay-out - economic scenario

- Digital economy allows supply of goods and services to customers across the world without any necessity of setting up physical presence in the relevant market or jurisdiction. The technological advancements have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without significant physical presence
- Business models under digitization rely heavily on intangible assets that involves royalty payout
- India stands third amongst BRICS countries in the Royalty payment and has paid almost USD 5 billion in 2015 which has grown year in year from USD 0.65 billion in 2005



Royalty pay-out - economic scenario (Cont'd)

- India's royalty payments regime was liberalized in 2010 ostensibly to increase the pace of FDI flows
- In the liberalized regime the royalty payout has increased and the royalty payout from the country has been 7% to 12.2% of the FDI inflow of the country during the 3 years period from FY 2011-12 to 2013-14
- Large pay-outs on account of royalty has been a concern with the Indian government and is being closely monitored
- In July 2018, Indian government considered a proposals for again introducing a restrictive regime for royalty payments and capping these payments at 4% of domestic sales and 7% of exports for first four years with caps on these tightening beyond this period for subsequent three years to the upper limits of 3% and 6% respectively
- SEBI recently amended the LODR* regulations which require Prior approval of shareholders for payments made to related parties by listed companies towards brand usage or royalty exceeding 2% of the annual consolidated turnover of the listed entity during a financial year from 1 April 2019. However the same has been deferred till 30 June 2019

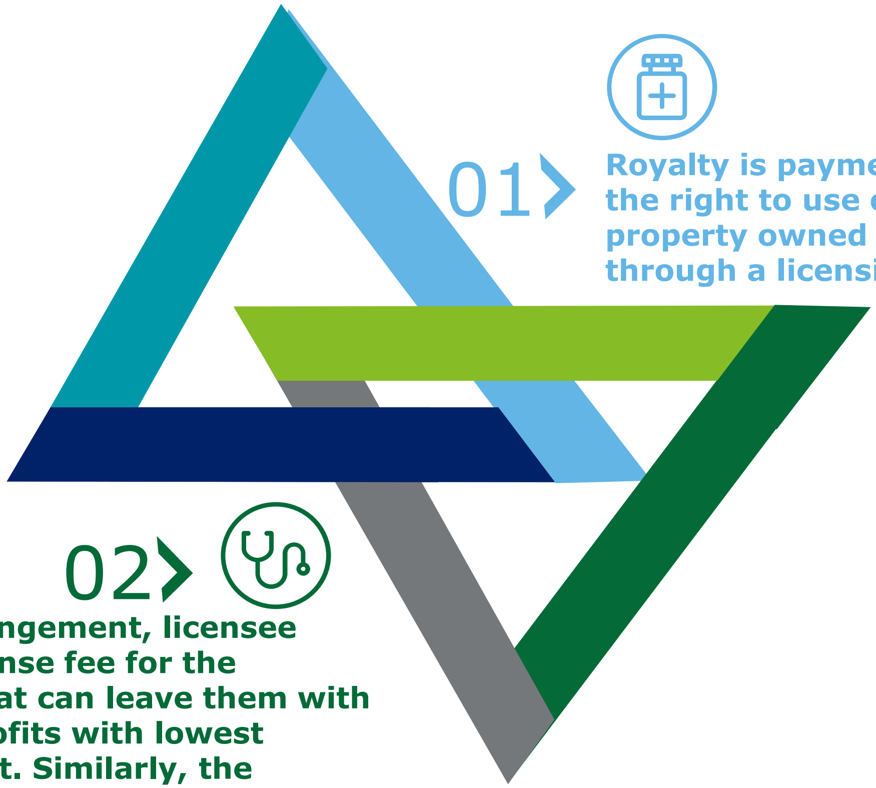
* As per Regulation 23(1A) of the SEBI (Listing Obligations and Disclosure Requirements – "LODR")

Traditional royalty models

Concept of royalty

- Royalty payment is referred to as:

  Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films, patent, design, trade mark, model, plan, secret formula, process, or information concerning industrial, commercial, or scientific experience



Royalty is payment for use of or the right to use of any intangible property owned by the other entity through a licensing arrangement

In an independent arrangement, licensee would agree to pay license fee for the intellectual property that can leave them with highest post royalty profits with lowest possible royalty pay-out. Similarly, the licensor would expect highest return from its intangible

Royalty models

Lump-sum royalty pay-out

- Lump sum royalty is generally "equivalent royalty amount", which is an advance payment of a stream of royalty payments over the life of an intangible
- Determination of an equivalent royalty amount requires a "present value of calculation based on an appropriate discount rate, and the projected sales over the relevant period"
- Projected sales should be tested periodically for a specified tolerance or forecasting error

Flexible royalty pay-out

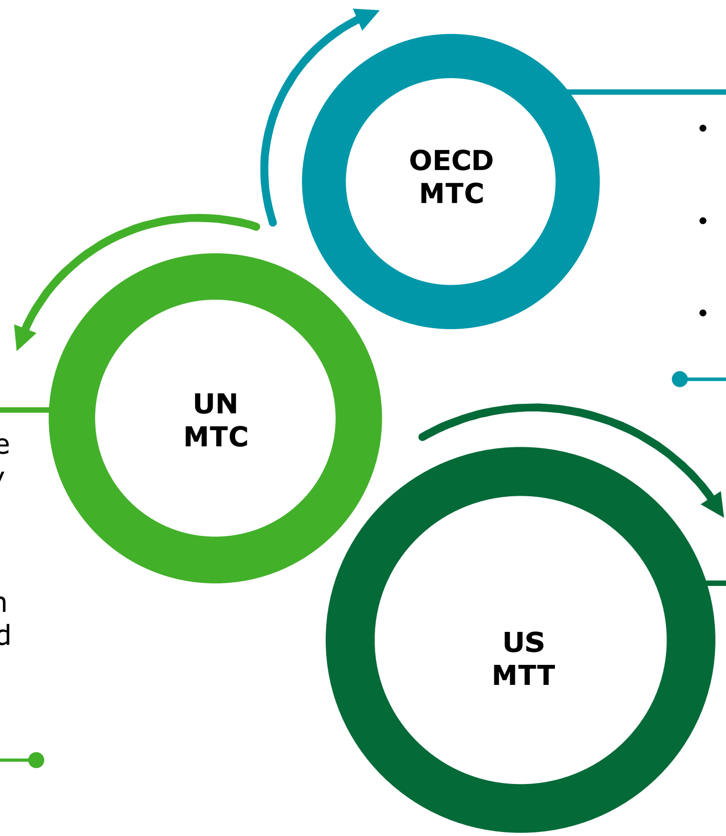
Turnover linked

- It is dependent on sales volume of the licensee
- Instead of single royalty, slab-based variable royalty can also be agreed
- Royalty rate increases with increase in sales of the products, sales slabs however should be determined based on the estimated sales potential of different products
- Turnover linked variable royalty payment in absolute amount increases due to (1) increase in sales volume and (2) increase in royalty rate

Profit linked

- Royalty is payable on profits in excess of minimum routine return (cost of capital + routine return from operations)
- It can be a single royalty rate or variable royalty rate based on the profit percentage
- This will ensure profit sharing between the licensor and licensee in the extra ordinary profits
- While determining profit linked royalty, endeavor is to keep minimum profits to remunerate routine functions for licensee and at the same time remunerate the licensor adequately in the event of super normal profits

Taxing rights over Royalty – a brief



OECD MTC

- Right to tax only lies with state of residence of recipient company
- Does not provide for Source country taxation (at all)
- Royalty definition is a bit narrow than that in UN MTC

UN MTC

- Primary right of tax lies with state of residence of recipient company
- Also provides for Source country to charge withholding tax on recipient, such rates depend upon the beneficial ownership threshold
- A much broader definition of "royalties" is included

US MTT

- Right to tax only lies with state of residence of recipient company
- Also provides for Source country taxation for connected persons, wherein recipient entity enjoys special tax regime in its residence state
- Royalty definition same as in OECD MTC

TP Litigation trends

- Royalty payout has been under detailed transfer pricing scrutiny. Close to 80% cases have been subjected to transfer pricing adjustment
- But, majority of these cases get relief at the higher appellate level
- A sample of 572 transfer pricing cases show that about 11% of cases were settled in favour of revenue. 35% of cases were settled in favour of the taxpayer and another 18% were partly favourable to the taxpayers. 36% of cases were remanded back for further scrutiny
- Major TP adjustments relating to Royalty payments revolve around the following: (i) Choice of MAM – TNMM v. CUP; (ii) Benefit Test; (iii) Use of Regulatory guidelines to justify Royalty rate; and (iv) Ad-hoc adjustments, i.e., restricting it to a specific threshold/ratio etc.

Summary of decisions of various ITATs over adjustments on royalty payments

APA experience - key considerations

Determination of the **routine arm's length profits** on the basis of the FAR profile

Actual/expected profitability of the taxpayer during the APA period

Determination of **excess profits earned/expected** to be earned by the taxpayer during the APA period and how much of it can be attributed to **contribution** of the AE and of the taxpayer through local sales and AMP efforts

Need & benefit test with substantial evidences.

Evidence & results of comparable uncontrolled arrangements between unrelated parties where there is an agreed spilt of profits/revenue between the licensor and the licensee of intellectual property

Justification on why India as a market, including taxpayer's operations/FAR, is different from the AE jurisdictions to warrant a different royalty rate/arrangement

Key insights on APA conclusions

- Number of APA agreements concluded so far for royalty payment. Most of the APAs are for trademark royalty and only 1 for technology royalty
- Trademark Royalty is generally restricted to 1-1.50% of sales in case of a bilateral APA, and 0.5-1% in case of unilateral APA
- Technology royalty in the range of 3-4% of sales in unilateral APA. Bilateral APAs, typically, would be more
- All these payments are generally restricted to availability of adequate profits. Royalty is generally not allowed in case of losses
- Sales for the purpose of computation of royalty is generally net of duties and taxes

Digital economy

What has transformed?

Renewed business models arising in a digitalized economy

The OECD Interim Report on tax challenges arising from digitisation (2018) has tried to identify and summarise the emergent business models in a digitalized economy.

Addresses the short coming that it is often not possible to classify an entire company into a specific type as digitalized companies.

Particularly the more established companies, that frequently have more than one business line.

Multi-Seller platforms: Platforms that allow end-users to exchange and transact while leaving control rights and liabilities towards customers mostly with the supplier

- Didi Chuxing, Airbnb, Weibo, Amazon Marketplace, Facebook, and UberEATS

Resellers: Businesses that acquire products, including control rights, from suppliers and resell them to buyers

- Amazon e-commerce, Alibaba, Spotify, and Netflix

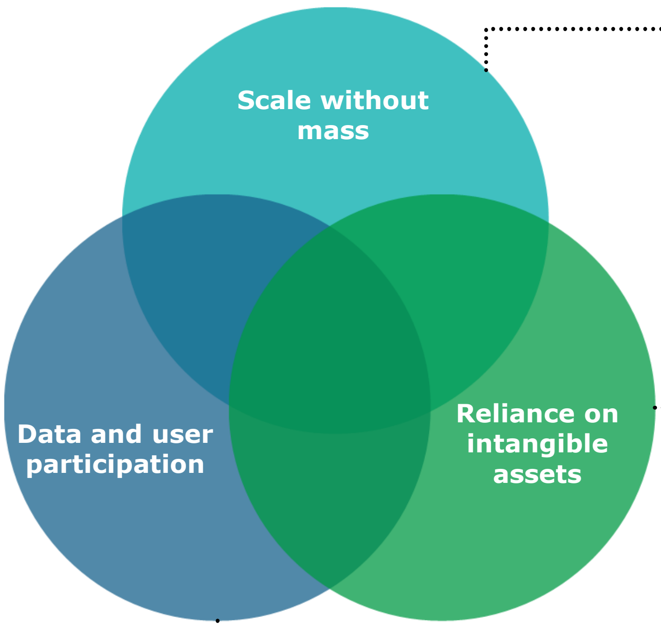
Vertically integrated firms: Businesses that have acquired ownership over suppliers and have integrated supply side of the market within their business

- Amazon e-commerce (warehousing and logistics), Xiaomi (end-user devices and applications), Huawei (Hardware and Cloud computing), and Netflix (film production)

Input suppliers: Businesses supplying intermediary inputs required for a production process of goods or services in another firm

- Intel and Tshingua Unigroup

Digital economy – what has transformed?



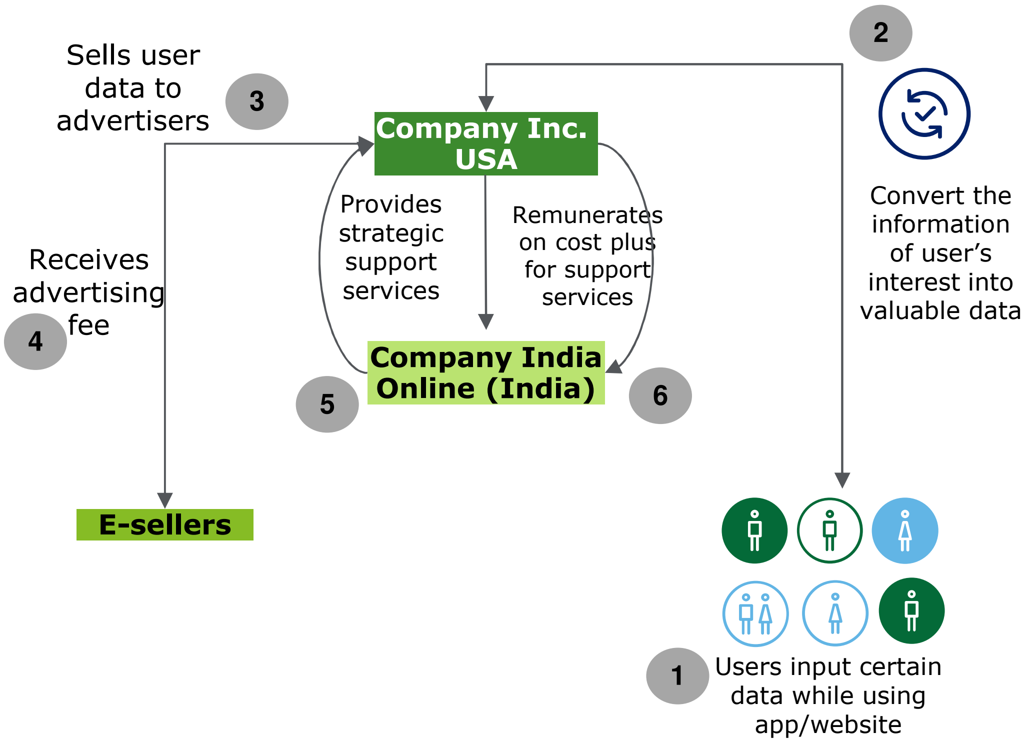
Highly digitalized businesses often are highly involved in the economy of a jurisdiction without any significant physical presence

Digital business models tend to have a heavy reliance on intellectual property assets, and are therefore more mobile

Higher level of value than currently assessed comes from users' participation in the digital activities that some platforms enable

The Action Plan 1 Report do not endorse ring fencing the digital economy and observe that – "Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes"

Digital business model – problem statement through example



The whole discussion on Digital economy is basically about how to divide the taxing rights for such income between US and Indian company, given that Indian Government considers that it is India based users who contributed to such profits made by Company Inc. USA, even though Company Inc. has not resorted to any tax avoidance/evasion scheme and rather have used legal/conventional means of doing business

- Company India performs strategic support services to Company Inc. USA, and received cost plus remuneration (which is taxable in India)
- It has millions of users in India which while using the website/application input certain data
- Company Inc. analyses user data to reveal patterns, trends, and associations, especially relating to human behavior and interactions, using data processing software like Big Data
- Company Inc. then sells such data typically organized as per specific user's interest to host advertisements for advertisers
- Company Inc. receives advertising fee from such third party advertisers
- Given that Company India does not constitute a PE of Company Inc. in India in the absence of any physical presence relating to such advertising function
- Therefore none of the advertising income of Company Inc. is taxable in India – since business income is taxable only in USA as per Article 7
- Unless, Indian authority can substantiate the advertising fee paid by Indian residents to Company Inc. is "Royalty", it cannot withhold any tax upon such payments, under prevailing tax provisions

Policy concerns and recommendations on taxation issues in Digital economy – Action Plan 1

Policy concerns for Digital Economy

1. **Nexus – Ability to have significant presence without being liable to tax, eg. no. of internet users, cab users, etc.**
2. **Data and value creation – How to attribute value to generation of data through digital products/services and how to determine profit share on the basis of this value**
3. **Characterisation of income – Tax treatment of income derived from new business models, i.e., whether as business income (no WHT) or as Royalty/FTS (with WHT)**

TFDE concluded that all three alternatives need further study and a report reflecting outcome of work on tax in digital economy is **expected to release by 2020**

Recommendations of TFDE to address above issues

Nexus based on Significant economic presence (SEP)

- Creating a taxable presence in a country when a non-resident enterprise has a SEP in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools. Following factors were identified
  - Revenue based factors
  - Digital factors
  - User based factors

Withholding Tax on Digital Transactions

- Consideration of WHT on payments by residents (and local PEs) of a country for goods and services purchased online from non-resident providers
- Such WHT can be imposed as a standalone gross basis final WHT or alternatively, can be imposed as a primary collection mechanism and enforcement tool to support the application of the nexus option

Introducing an equalization levy:

- Scope of levy focuses closely to situations in which a business establishes and maintains a purposeful and sustained interaction with users or customers in a specific country via an online presence
- Either of three options could be followed for applying Levy
  - Only where the business maintains a SEP; or
  - Only to transactions concluded through automated systems; or
  - On data and other contributions gathered from in-country customers and users

Polling question 1

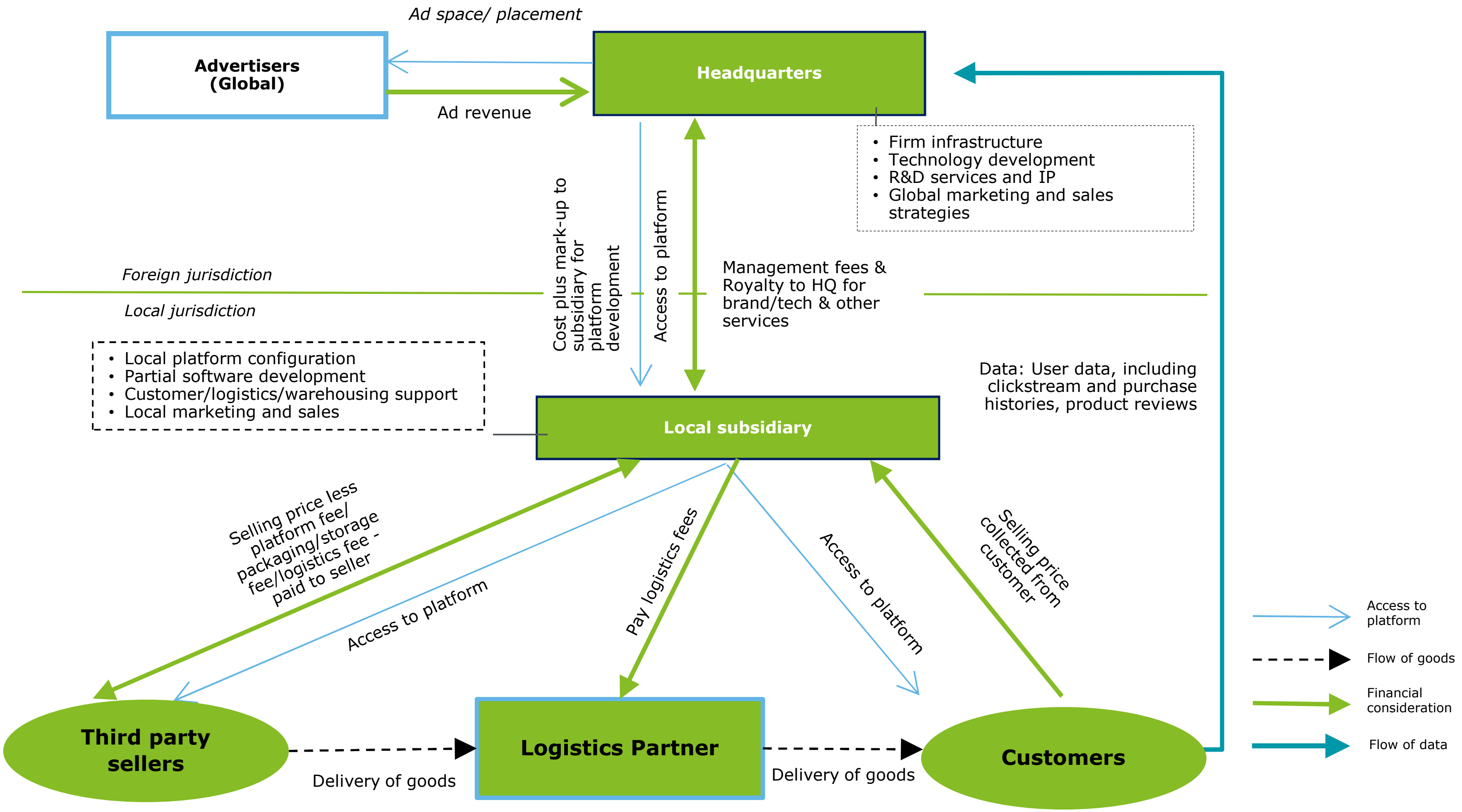
Do you think with greater integration of business activities, there will be a greater need to consider sets of related party transactions rather than to consider each transaction separately?

- Yes
- No
- Maybe
- Don’t know/not applicable

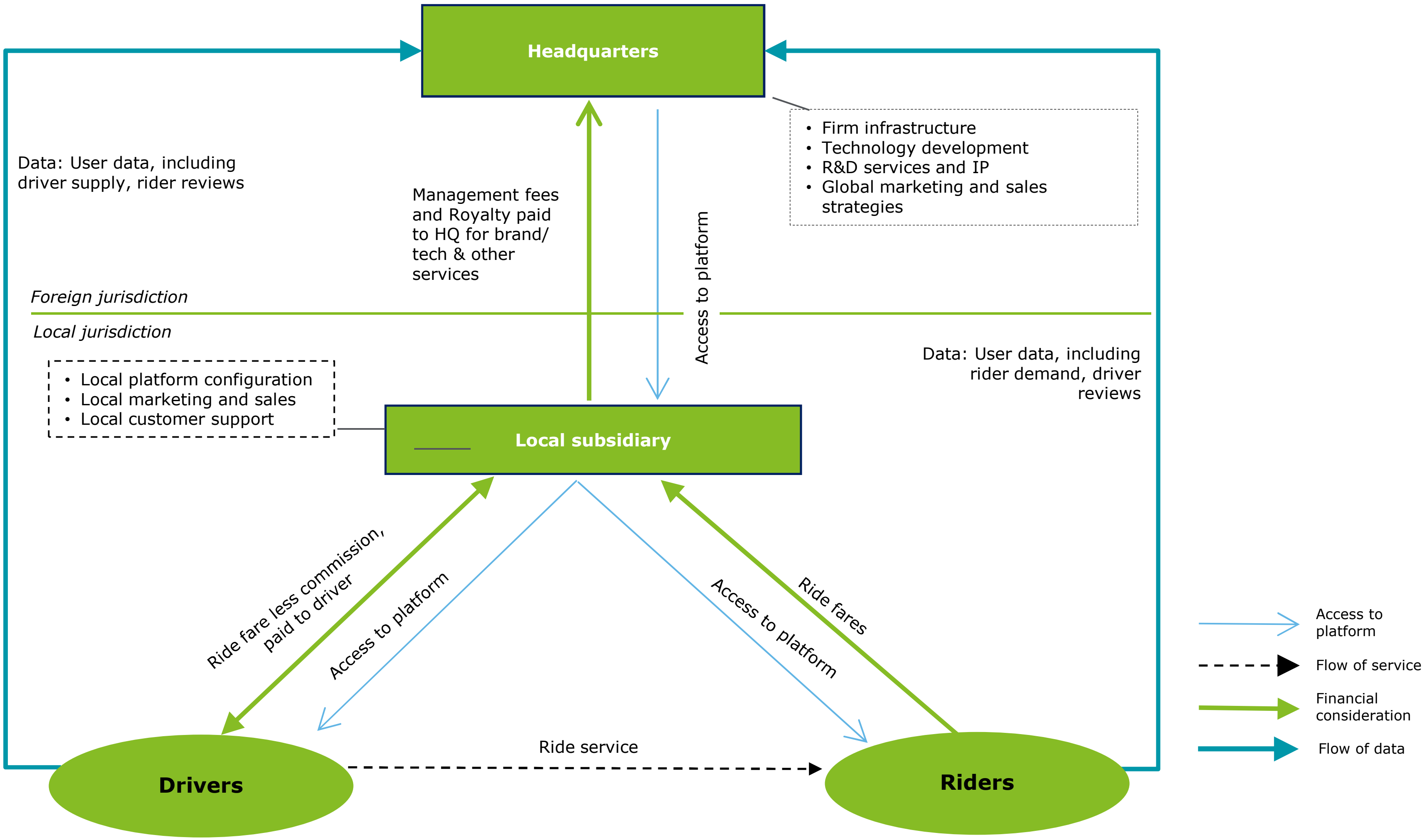
Digitization – where is the value creation?

Case studies

Case study 1: E-Commerce



Case study 2: Cab aggregator



Difference between traditional model and digital model

Platform

Traditional model - Physical retail stores/regional dispatch offices close to customers

E-business - Development and real-time update of digital platform

Network of sellers and customers

Traditional model - Network of sellers/drivers, warehouses, retail stores and dispatch offices

E-business - Direct link of sellers/drivers and customers

Pricing

Traditional model - Limited scope for reduction of prices due to marginal cost

E-business - Scope for differential prices for customers due to minimal marginal cost

User experience

Traditional model - In-store manual feedback and demand for the product via market research, including surveys or cab bookings done via telephone calls

E-business - Targeted advertising through instant feedback, demand for product, user traffic on platform and instant booking of cab using app

Potential value creators

New intangibles

- Platform development support activities performed by subsidiary may be considered to contribute to development of Intangible Property, i.e., “Platform”
- Moreover, apart from traditional technology intangibles: computer software, data, application, network, algorithms, etc., may also be considered as potential new intangibles

User participation

- User participation creates value by their contribution and participation in the network. The users overall may enhance the company’s intangibles, expand the brand’s recognition and improve the platform’s performance
- Generation of valuable data and market power through development of critical mass

Marketing intangible

- Advertising, marketing and promotion activities performed by subsidiary may lead to creation of marketing intangible
- In the case of Cab-aggregators, contracts between the subsidiary with the drivers be considered as an intangible that is ought to be valued
- There is considered to be an intrinsic link between marketing intangibles and the market jurisdiction

Polling question 2

Do you think whether “Platform”, “Users”, or both are new type of intangibles?

- Yes – only platform
- Yes – only users
- Yes - both
- None

How to determine royalty payout?

Need for look beyond arm's length principle

Evolution – intangibles

Traditional
Patents, Trademarks, Licenses etc.

New age
Networks, Platforms, Servers, Algorithms etc.

Still developing
Hard to value intangibles

Traditional methods - still holds good – to value new age intangibles?

Traditional methods

CUP/TNMM

One sided methods

- **Complex business models**
- **Highly integrated business operations**
- **Data, user participation and network effects**
- **Synergy benefits**
- **Unique and valuable contribution**

New method – multisided approach

Transactional Profit Split Method/Formulary approach

does not consider

considers

Nexus and profit allocation proposal

The key features of Public Consultation document released by OECD on 13 February 2019

Particulars	User participation proposal	Marketing intangible proposal	SEP proposal
Nexus	• Focuses on highly digitalised businesses • User participation is seen as a significant contribution to value creation	• Intrinsic link between marketing intangibles and the market jurisdiction • Proposal to tax market jurisdiction	• A taxable presence would arise where there is a purposeful and sustained interaction with the country through digital technology
Method	Residual profit split	Non-routine residual profits can be determined through: • Normal transactional TP principles or • Revised profit split analysis	Fractional apportionment method
Recommended allocation Keys	User base	Sales and AMP expenses	Sales, employees, assets, users, etc.

Challenges in application of PSM

- **Identifying the relevant cost and revenue**
- **Making adjustments in accounting practices and currency**
- **Documenting the profit split factors**
- **Application in case of losses**
- **How to determine non routine profits and their tax jurisdiction**

DST/EL

Couple of countries have introduced digital service tax/equalization levy, however, the same are in the nature of indirect tax and cannot replace profit attribution

- India – 6% EL
- European Union – 3% DST
- Spain – 3% DST
- UK – 2% DST

- **OECD interim report suggests great degree of technical attention in application of: Residual Profit Split method and fractional apportionment method**
- **Further, it outlines number of areas where there are clear difference of views held by countries that needs to be resolved**
- **OECD final report will be delivered in 2020**

Polling question 3

Do you think that transfer pricing methods' landscape is likely to change with digital transactions?

- Yes
- No
- Not sure

Unilateral actions on Digital Economy

A global overview

India – developments on taxing digital economy

Equalization levy

- Equalization Levy was introduced in India in Finance Act **2016**
- The intent was to tax the digital transactions **at 6% of gross consideration** on the income accruing to foreign e-commerce companies from India
- Primarily covers online advertisement services and any provision for digital advertising space for the purpose of online advertisement
- Equalisation levy not to be charged if:
  - Non-resident has a PE in India; or
  - The aggregate amount of consideration for specified services does not exceed INR 1 lac in the previous year; or
  - The payment for the specified service is not for purpose of carrying out business or profession

Significant economic presence

- Concept of **Significant Economic Presence (SEP)** introduced to provide that a non-resident‵s SEP in India shall constitute "**business connection**" of the non-resident in India
- The aim is to bring the income earned by way of such SEP by non-resident, under the tax net in India
- The **threshold limits** for qualifying as "SEP" **are yet to be notified** by the government. The said provisions come into force from 1 April 2019
- However, the **practical application** of the "significant economic presence" concept **largely depends upon cooperation from India's tax treaty partners** since under the section 90(2) of the Act, the taxpayer is eligible to apply the treaty provisions over the Act wherever more beneficial
- Thus, until such amendments are made in the treaties, this concept would remain domestic law. Therefore this is not expected to have any immediate impact on the digital economy

Digital Tax in other countries on e-services

European Union – Digital Services Tax

- Aim of Levy: ensure that those activities which are currently not effectively taxed would begin to generate immediate revenues for Member states
- What it postulates: Interim 3% Digital Services Tax (DST) on gross revenue made from 3 main types of services where the main value is deemed to be created through User participation, i.e.,
  - Online placement of advertising;
  - Sale of collected user data; and
  - Digital platforms that facilitate interactions between users

UK– Digital Services Tax

- UK announced the levy of digital services tax of 2% on tech giants in its Budget on 29 October 2018
- Advertising and streaming services have been specifically brought within the tax net
- The said tax would be effective from 1 April 2020 and would largely be levied on revenue generated by large social media platforms, search engines and online marketplaces pertaining to UK users

Spain – Digital Services Tax

- Spanish budget announced on 12 October 2018 has proposed to introduce digital tax @ 3% on digital services like revenue from sale of online advertisements, digital intermediary and brokerage services etc.
- Tax levy is subject to revenue thresholds based on global revenue as well as domestic revenue from digital services being met

Japan - Consumption tax

- Japan introduced Japanese consumption tax (JCT) of 8% with effect from 1 October 2015 on revenue from cross border sales of e-services to Japanese consumers
- E-services include e-books, cloud based services, online advertising, gaming, streaming etc. The rate of tax will be increased to 10 percent from October 2019
- The registration threshold has been prescribed at JPY 10 million during tax base period
- Merchants who sell digital services to Japanese customers via telecommunication network are required to register for JCT purposes

Questions and answers

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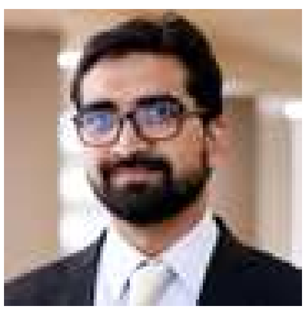

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