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1 article

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Royalty is one of the most litigated international transactions in the transfer pricing space in India. Royalty is the consideration paid for right to use intangibles i.e. technology/technical know-how, trademarks, brand names etc. The compensation model adopted could be of various types – Lump sum payment, Running royalty (a fixed percentage of sales/profits, rate per unit), Variable royalty – routine profits in India and balance profits remitted as variable royalty, Staggered royalty (which varies according to the level of sales/profits).

Issues faced during assessment

During the course of assessment proceedings before the Transfer Pricing Officer (TPO) and subsequent forums, the common aspects scrutinised are the need-benefit for carrying out the royalty transaction between the assessee and its Associated Enterprise (AE) and the method of determining the Arm's Length Price (ALP).

It is observed that taxpayers generally adopt Transactional Net Margin Method (TNMM) as the Most appropriate method (MAM) for benchmarking royalty by aggregating it with other international transactions. Most of the TPOs emphasise on the transaction level testing of the royalty transaction and then decide the allowability of this transaction. There is a request for a separate Royalty benchmarking to be provided by the assessee. As most of the tax payers adopt TNMM, they have two options - either they check with their parent company whether such CUT

analysis is available for the relevant year or they proceed to carry out the analysis using Global Royalty databases (Royalty Range, Royalty Stat, ktMINE) which have details of CUT agreements.

The next important aspect raised by the TPO is the need for a well-established company to pay year-on-year royalty where there is no evidence of any additional updates to technology. The expectation has been that when an assessee pays a running royalty there should be some incremental benefit received by the company on a yearly basis.

Also, in case if the Indian entity has an R&D team, the role played by them is scrutinised and also whether any updates/improvements carried out by them are being utilised by other group entities.

Royalty payments made when the Indian company incurs losses is adversely viewed.

Further, in relation to brand royalty, where there is a significant amount of AMP spend in the Indian market by the Indian company, the need for such brand royalty is also questioned as it is viewed that the Indian entity is building the brand of the Foreign entity in India.

After questioning on these aspects, the TPOs proceed to carry out a downward adjustment on the royalty payment such as:

- 1) Ad-hoc disallowance of royalty under Comparable Uncontrolled Price (CUP) method without analysing or providing details of any comparable transactions
- 2) Application of CUP method and restricting the royalty rate paid by the assessee to the average royalty paid by the comparable companies identified for benchmarking the other international transactions (eg: sales, purchases). However the royalty paid by these comparables will be limited considering only uncontrolled transactions can be used for comparison and many of these companies might carry out their own R&D activities Further, in certain cases, the comparable rates are adopted by the TPO without proper analysis of nature of payments (Eg: in the instance

of cement manufacturing companies, TPOs have considered mining royalties paid by companies to the government towards extraction of limestone, for comparison with royalty paid for technical know-how)

3) Some TPOs have also resorted to using Other method as against CUP to eliminate the need of providing comparable information by relying on the language - 'price which has been charged or paid, or would have been charged or paid for the same or similar uncontrolled transactions' present in the TP regulations.

Approach for defending royalty

Some of the practices which can be followed for defending this international transaction is

1) Maintenance of adequate documentation (including basis of arriving at royalty rate, details of yearly updates to technology, call logs of queries resolved, benefits derived in terms of increase in sales/profitability etc.).

2) Though availability of Internal CUPs would be limited, one may still need to check for the same. Considering the data available with TPOs regarding comparable license agreements is limited as accessibility to foreign royalty databases is not available to the TPOs, a CUT search is usually requested from the assessee during the course of assessment or even when the assessee wishes to opt for an APA. While preparing a CUT analysis, various comparability factors are to be considered including nature of Intellectual Property, geographical location, term of the agreements, exclusivity etc. Off late we are given to understand in some jurisdictions, the TPOs have access to Foreign royalty databases.

3) Value chain analysis to capture the DEMPE (Development, Enhancement, Maintenance, Protection, Exploitation) activities carried out by the parties who contribute to the IP

4) In instances where TPOs adjust the royalty transaction by stating that the comparable companies do not pay any royalty, one could provide details of research and

development expenditure, research facilities etc (as available from the annual reports, websites of comparables) to demonstrate that these companies undertake R&D activities on their account and henceforth the need for payment of royalty does not arise, unlike the assessee who does not perform such activities

5) In case if the TPO does not provide any comparables, the assessee should contend that it is the onus of the TPO to provide an alternative comparable analysis if the assessee's benchmarking analysis is rejected.

6) Evaluating the applicability of other TP methods including the Profit split method, where multiple entities, including the assessee, contribute to DEMPE of IP.

There have been instances when appellate forums have provided relief by allowing the aggregation of royalty transaction under TNMM depending on specific facts. It is essential to be proactive and have robust defence for substantiating the payment of royalty.

Other aspects

Advance pricing agreement (APA) would provide a good avenue to provide certainty in relation to royalty transactions on an amicable basis. Moreover, APA authorities may be more flexible in accepting complex approaches for determining the ALP.

Apart from the conclusion of running royalty for technology and trademark, in recent times, in light of the changing economic landscape there has been a move towards applying variable royalty to compensate the value generated by different parties. A bilateral APA was concluded with UK concerning a variable royalty structure for technology and trademark using the Profit split method^[1]. An APA was also signed with Switzerland for a variable royalty structure using Residual Profit split method.

Further, as per APA annual report released by the CBDT, royalty was one of the top transactions covered in the APAs

concluded[2].

Changing landscape

One needs to also bear in mind that the business landscape has been changing where competitors tie up/form strategic alliances to bring out new products (e.g Maruti and Toyota) and there is a hybrid cross over of the technology of two Groups- all this would still complicate the royalty payout. Further introduction of new kind of products- eg: EVs in the auto industry where there is a huge amount of investment in R&D and how this cost would be shared in future with those entities who are exploiting the EV technology. In case of new models for sale- like subscription models, how would the royalty be paid to the owner of the IP- there should be alignment with the recognition of revenue.

Considering the dynamic environment, one needs to present the TP analysis after considering all nuances of the transactions including understanding the industry structure.

[\[1\] CBDT inks Bilateral-APA with UK on variable royalty based on profit-split method | Taxsutra](#)

[\[2\] APA Annual report released by the CBDT for the FY 2018-19](#)

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In the attached article we have presented our analysis on [#royalty](#) payment, which is a highly litigated transaction in the [#transfer](#) pricing landscape in India. The broad aspects covered in the article are the common issues faced during the [#assessment](#) proceedings, recommendations on approach for defending royalty and the changing landscape for the transaction in recent times.

Considering the high quantum of adjustments made by the tax authorities, it is essential to be proactive and have robust defence for substantiating the payment of royalty.

How we can support:

1. Support in maintenance of cost benefit analysis [#documentation](#) to substantiate royalty payment
2. Performance of [#CUT](#) search using Global Royalty database to identify comparable license agreements and determine the [#arm's](#) length royalty range
3. [#Audit](#) Defense before all forums - Transfer Pricing officer, Dispute Resolution Panel, Commissioner of Income Tax (Appeals) and Income Tax Appellate Tribunal
4. Analysis of [#DEMPE](#) functions
5. Assistance in [#APA](#) proceedings

In case of any support or clarifications on the above, please reach out to us at snithya@vstnconsultancy.com