

Annexure 2

Royalty Income

1 Existing tax provisions

The definition of “Royalty” under the Income Tax Act, 1961 (the Act) inter-alia includes any consideration (including any lump sum consideration, but excluding income chargeable as capital gain) -

- for the transfer of all or any rights (including granting of licence/sub-licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property.
- for imparting of any information concerning working of or use of any patent, invention, model design, secret formula or process or trade mark or similar property
- for the use of any patent, invention, model design, secret formula or process or trade mark or similar property
- for imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill

As one would observe, the scope of this definition is very wide and it is possible to contend that this definition covers majority of transactions pertaining to valuable rights.

Currently, various countries have been contending that E-commerce transactions do not require any special regime of taxation and current principles should be applied, with marginal variation, to E-commerce transactions. Further, there should be a tax neutrality between the ordinary mode of conducting business and electronic form of commerce. Finally, in case of a bundled transaction, it is not a practice to break down the entire transaction into small components. Instead the practice is to apply the principles which hold good for the predominant element of transaction, to the entire transaction.

The OECD has advocated the above principles. OECD has further mentioned that in relation to royalty characterization of E-commerce transactions, the principles applied to characterization of software transaction, should be applied.

2 Commentary on Article 12 of the OECD Model Convention

The basic methodology of the OECD Model Convention is one of classification and assignment. That is income must first be classified in the relevant treaty category and the taxing rights with respect to that class of income are then assigned to one or both Contracting States in the substantive treaty articles.

The amended OECD Commentary¹ recognises that the character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in a computer program are a form of intellectual property. Although the term computer software is commonly used to describe both the program – in which the intellectual property rights (copyright) subsist – and the medium on which it is embodied, the copyright laws of most OECD member countries recognise a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program². Transfers of rights in relation to software occur in different ways, ranging from the alienation of the entire rights in the copyright in a program to the sale of a product subject to restrictions on the use to which it is put. The wide spectrum may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment³.

The OECD Commentary broadly identifies the following types of software transactions for purpose of determining the classification for tax purpose⁴:

- Transfer of partial or complete rights in the underlying copyright.
- Transfer of partial or complete rights in a copy of the program (program copy).
- Transfer of know-how in a computer program.
- Mixed contracts, such as sale of computer hardware with built-in software or concession of the right to use software combined with provision of services.

Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder)⁵.

Where consideration is paid for the transfer of full ownership of the rights in the copyright, the payment cannot represent royalty and the provisions of Article 12 are not applicable. Difficulties can arise where there are extensive but partial alienation of rights involving – exclusive right of use during a specific period or in a limited geographic area; or additional consideration related to usage; or consideration in the form of a substantial

¹ As per amended OECD commentary released in June 2000.

² *It may be noted that no such distinction is apparent under the Indian copyright laws.*

³ *Paragraph 12.2 of the OECD Commentary*

⁴ *Paragraphs 13 and 17 of the OECD Commentary*

⁵ *Paragraph 13.1 of the OECD Commentary*

lump sum payment⁶. These transactions are the hardest to classify as they have economic elements of both a sale and a licence. The Commentary provides little guidance here and states that each case will depend on its particular facts but in general such payments are likely to be commercial income or capital gains⁷.

In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of the computer programs. Rights in relation to the program which do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purpose. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7⁸.

3 Applicability in Indian context

Currently, the above mentioned principles advocated by OECD have not been adopted or ratified by the Indian Tax Authorities. In our view, there is an urgent need to adopt these principles of characterisation to enable correct allocation of income between India and other jurisdictions. Such adoption / ratification shall further help in applying these / similar principles for proper classification of E-commerce transactions.

The TAG to CFA of the OECD has been attempting to bring consensus on the issue of characterisation of income arising from various E-commerce transactions.

In respect of royalties, the group observed that main question to be addressed was the identification of the consideration for the payment. The group agreed that, where the consideration is for something other than rights in copyright, and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer or network, such use of copyright should be disregarded in the analysis of the character of the payment for tax purposes.

⁶ Paragraph 15 of the OECD Commentary

⁷ It may be noted that Article 12 of the US treaty defines royalty to include consideration arising on alienation of a copyright, provided the consideration is linked to usage. As the facts of this case do not come within the ambit of these provisions, the same is not relevant.

⁸ Paragraph 14 of the OECD Commentary.