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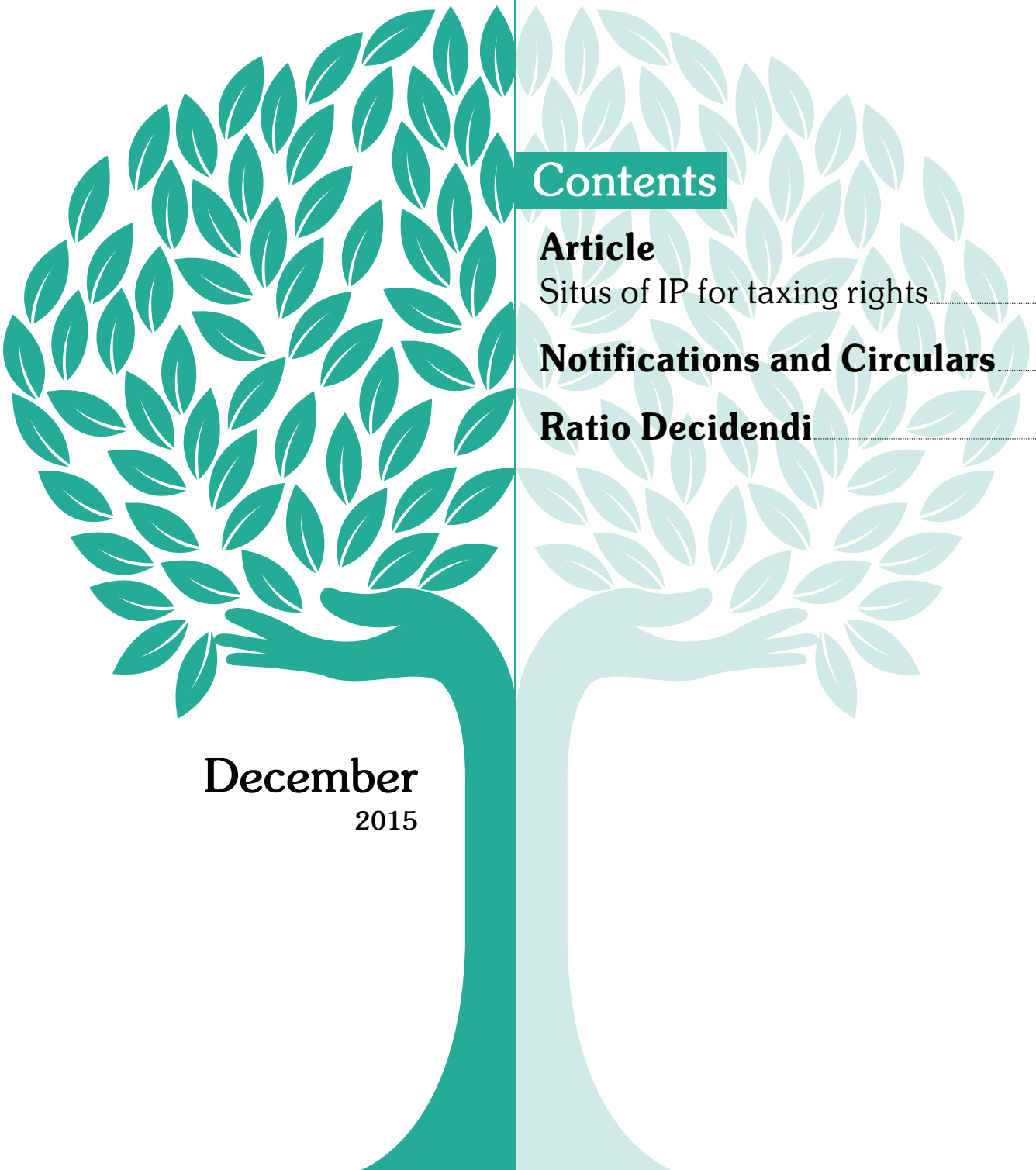

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Situs of IP for taxing rights

By **Lakshmi Pavan**

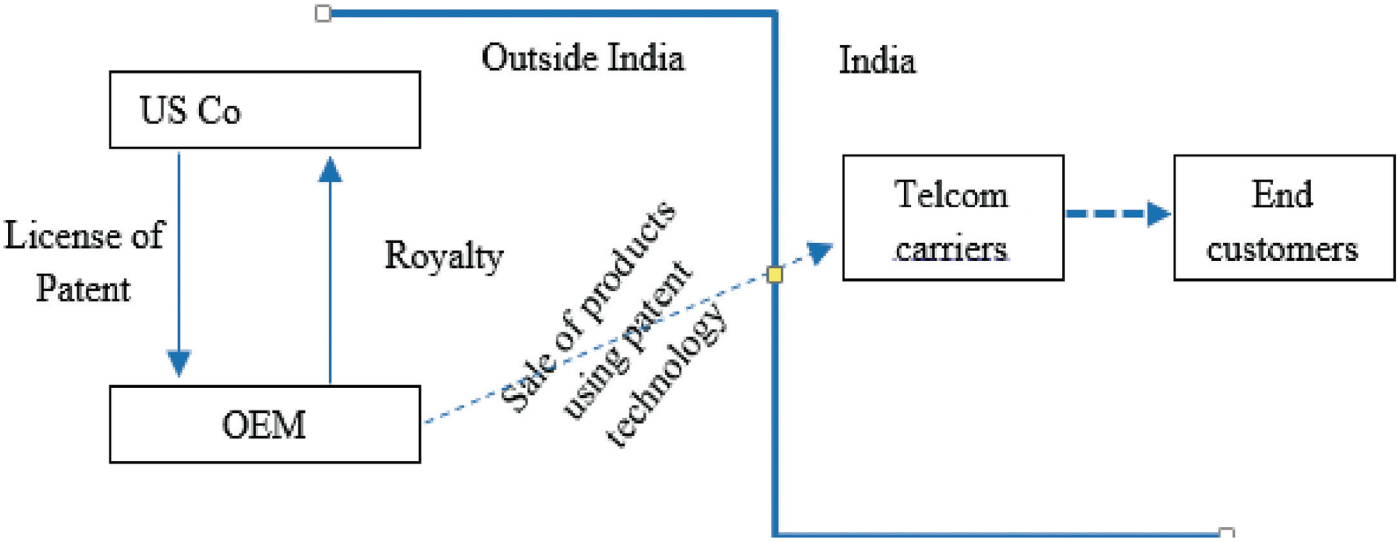
The penetration of digitalization in every sector of the economy is a challenge from taxation perspective. Given the global nature of operations, it is possible for multi-national enterprises (MNEs) to fragment their production and supply chain across various low tax jurisdictions. They park and manage the Intellectual Property ('IP') in one tax jurisdiction, to carry out production and delivery systems from multiple tax jurisdictions. In a digital era determining the 'situs' of an IP embedded in a product sold internationally is the biggest challenge. The final products pass through many tax jurisdictions and may not be taxed either due to the arrangement of activities and business models in line with the treaty provisions and domestic law of each jurisdiction.

The benefits that MNEs get are

(a) reduction in tax burden and

(b) low risk by creating multiple tax presence.

Illustrative example



In the above illustration, US Company (US Co) designed, developed, manufactured and marketed the digital wireless communication products which work on CDMA technology. The CDMA circuits, systems software along with license to manufacture the wireless products was granted to Original Equipment Manufacturers (OEMs) who were also situated outside India. The US Co. charged fees for the license granted and also charged a royalty fee for the products sold using the patented property. It received royalty from manufacturers of OEMs who sold handsets in India. The Indian tax authorities disputed that the royalty income received against sales made in India is liable to tax in India.

A similar cross-border dispute had come up for adjudication before the Delhi Tribunal in

the case of *Qualcomm*[1].

Similar challenges would be faced by all such cross-border MNEs when countries exercise their right to tax on the embedded portion of the IP, especially when the domestic tax law permits to tax such income[2].

Right to tax is linked with Situs

Before exercising right to tax , it is always essential to ascertain, what is the situs of an IP? Whether the right to tax is vested with tax jurisdiction in which the products are manufactured, i.e. the situs of manufacture of products, or in the tax jurisdiction where the products are used, i.e., the situs of use of products ?

The Madras High Court in *Anglo French Textiles*[3] laid a preposition that the right to tax is with the country where the manufacturing activity takes place. Though not in the similar context but in different context, in *Lufthansa*[4], *Havells*[5], *Metro & Metro*[6]*& Titan*[7], the Courts accepted the above principle. This principle is effective when the underlying property is a tangible asset. But when the underlying property is an IP, this principle may not hold good.

IP have no physical existence, occupy no space and therefore can have no actual location. In order to confer jurisdiction over IP, courts have to ascertain the real and actual situs of IP.

In *Qualcomm* case, the Delhi Tribunal mentioned that royalties for use of a technology is taxable in the place where the technology is used. Accordingly, when the royalty is for use of a technology in manufacturing, it is to be taxed at the situs of manufacturing the product, and when the royalty is for use of technology in functioning of the product so manufactured, it is to be taxed at the situs of use.

Before, applying above preposition, courts must first have to ascertain the real and actual situs of IP and exercise the taxing right.

Guidance on finding out the real and actual situs of IP

IP is a peculiar form of intangible property. A trademark affixed to a tangible product is present wherever the product is shipped, offered for sale, and consumed. A copyright is an intangible, yet has a presence wherever a tangible copy of the copyrighted work is transported and used. A trade secret or a patent is embodied in the tangible, movable, and physical machinery, process, product, or method.

Where is the situs of a trademark, copyright, trade secret, or patent? According to US trade secret law, trade secrets have a fictional situs

1 56 taxmann.com 179 (Delhi - Trib.)
2 Section 9(1)(vi)(c) provides for such chargeability
3 [1993] 199 ITR 785 (Mad.)
4 [2015] 278 CTR 1 (Delhi)
5 [2012] 253 CTR 271 (Delhi)
6 [2013] 158 TTJ 308 (Agra - Trib.)
7 [2007] 11 SOT 206 (Bangalore)

where the trade secret owner resides. Indeed, numerous US courts have held that IP protected under state law, the holder's state residence is the situs of the IP. Federal trademarks, copyrights, and patents, on the other hand, are not protected under state law; they are protected under federal law. Trademarks, copyrights, and patents, therefore, do not have situs in their state of origin; they instead have no real situs, apart from the domicile of the holder. In other words, the state in which the owner of intellectual property resides is the situs of the IP.

The US Supreme Court in *Quill*[8] held that a taxing state must establish the physical presence of out-of-state companies within its jurisdiction in order to exercise taxing statute to pass constitutional muster.

To conclude

As IP assets continue to be valuable corporate assets, holders of such assets will seek ways to legitimately minimize tax burdens in their quest to maximize overall corporate revenue and profit. States that want to extend their taxing power on IP holding companies should first have some understanding of the nature of IP rights. Sound tax policies should take into account the interest of IP rights holders and then balance those interests with domestic taxation rules.

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Notifications and Circulars

Amendment to reporting requirements for payments made to non-residents

The CBDT has issued Notification No. 93/2015 (F.No.133/41/2015 –TPL) dated 16-12-2015 amending Rule 37BB of Income Tax Rules, 1962 regarding furnishing of information for payment to a non-resident, not being a company or to a foreign company. As per the amended rules which will come into effect from 1-4-2016, for payments of any sum chargeable to tax, exceeding agreement of Rs.5 lakhs information is to be furnished in Part A of Form 15CA. In other cases the person responsible for making the payment should furnish information in Part B of Form 15CA after obtaining a certificate from the Assessing Officer under Section 197 or order under Section 195. Information is not required to be furnished for sums which are not taxable when remittance is made by an individual which does not require prior approval by the RBI or those which are mentioned in the specified list as per the notification. The list includes imports below Rs. 5 lakhs, payments for maintenance of offices abroad and payment by resident for international bidding.

Communication of notice and summons by e-mail

Rule 127 has been inserted in Income Tax Rules, 1962 by way of Notification No. 89/2015 (F.No.133/79/2015-TPL) dated 2-12-2015, providing that communications – notice, summons, requisition, order or any communication under the Income Tax

[8] *QuillCorp. v. North Dakota* 504 U.S. 298 (1992)

Act, 1961 shall be made to email address available in income-tax returns, email address of company as available on the website of Ministry of Corporate Affairs or address made available to the income tax authority. The rule will come into effect on date of publication in the Official Gazette.

Monetary limits for appeal by Department – Retrospective revision of limits

By way of Circular No.21/2015 dated 10-12-2015, the monetary limits for filing of appeal by the Department have been revised. Appeals are not to be filed before the ITAT where tax effect does not exceed Rs. 10 lakhs, before High Court where tax effect does not exceed Rs, 20 lakhs and before Supreme Court where tax effect is not more than Rs. 25 lakhs. Filing of appeal should be decided on the basis of merits of the case. The limits will not apply to questions of constitutional validity of provisions, undisclosed foreign assets and audit objection accepted by the department. These limits shall apply retrospectively and pending appeals below the specified limits have been instructed to be withdrawn.

Ratio decidendi

Attribution of profits even when transactions are at ALP: At issue was the attribution of profits to the assesse reasoning that it had a Dependent Agent Permanent Establishment (DAPE) through it's AE in India which 'sold advertisement time' and also distributed the channel in India. The Indian AE received a commission for procuring advertisement contracts. The transactions with its AE were accepted as being at Arm's Length Price (ALP) by the revenue. However the revenue authorities contended that since 'advertisement time' was not a good, it could not be sold and though the agreement between the AEs was stated as 'Principal to Principal' basis, the Indian AE was acting as an agent. The assessee argued that the Indian AE entered into contracts for procuring advertisements in its own name and acted in independent capacity. Thus, no PE was created in India and since transactions were at ALP, there can be no attribution of profits. The tribunal held that when a foreign company receives money from India, if it is held to have a PE, profits have to be attributed accordingly. [*NGC Network Asia LLC* v. *JDIT*, ITA.7994/Mum/2011, ITAT, Mumbai order dated 16-12-2015]

AMP expenses – Not always an international transaction: The Revenue Department sought a transfer pricing adjustment as regards expenses made towards AMP made for promoting the 'Maruti-Suzuki' brand. The Indian AE – manufacturer questioned whether the transaction could be termed as an international transaction as there was no prior arrangement between the AEs regarding the expenditure. The Revenue argued that such expenses would necessarily be a matter of negotiation between the manufacturer-license and the foreign AE. Further, the expenses were excessive and the expenses had also benefitted the foreign brand and this brought it within the ambit of transfer pricing. The High Court opined that existence of an international transaction cannot be inferred from the AMP expenditure being excessive and mere fact that

an Indian AE is engaged in brand promotion of a foreign brand does not mean that there is an arrangement with the foreign AE. Also, on facts the brand did not belong to the foreign AE alone and expenditure towards royalty for logo, use of patents had been subject to transfer pricing separately. Thus, the High Court held that AMP expenses incurred could not be categorized as an international transaction. [*Maruti Suzuki India Ltd* v. *CIT*, ITA No.110/2014, Delhi High Court judgement dated 11-12-2015]

TP adjustment does not indicate that inaccurate particulars were furnished: Observing that merely because it is possible to arrive at two different estimates of arm's length price, it cannot be said that the lower of the two estimates is based on inaccurate particulars, the ITAT held that no penalty can be levied on the assessee under Section 271(1)(c) of the Income Tax Act, 1961. The assesse urged that the transfer pricing study had been prepared with the help of an independent expert and there was also no dispute over the study. The Tribunal held that the pricing had been done in good faith and with due diligence and there was no case to levy penalty merely because there was an upward adjustment to the price on account of different set of comparables. [*Babcock & Brown India Pvt. Ltd* v. *DCIT*, ITA No. 2214/MUM/2015, Order dated 20-11-2015, ITAT, Mumbai]

Taxability of compensation when entitlement to same in dispute: The revenue authorities contended that compensation, enhanced compensation and interest received by the assesse upon transfer of *Bhumidari* rights in land was taxable under the head capital gains. However, on facts, the assessee's entitlement to receive the compensation was under dispute and the final decision of the Court was awaited. The High Court therefore held that while the amounts were taxable, no right to receive the same had accrued to the assesse and hence it cannot be taxed in his hands. [*CIT* v. *Suman Dhamija*, TS-697-HC-2015(DEL)]

Production of radio programmes is manufacture of a 'thing': Examining the eligibility for additional depreciation on plant and machinery 'used' in manufacture of a 'thing', the Delhi High Court held that the assesse, engaged in the business of radio broadcasting was eligible for the same. The revenue argued radio programmes cannot be termed articles and hence the assets had not been used in manufacture of an article or a thing. The Tribunal held that a thing could have an intangible characteristic and production of radio programmes is manufacture of a thing. Hence, additional depreciation could be allowed. [*CIT* v. *Radio Today Broadcasting*, ITA 190/2015, Delhi High Court judgement dated 9-12-2015]

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