

TAXATION OF INTELLECTUAL PROPERTY RIGHTS (IPR'S)

Intellectual Property Rights Are Intangible Assets

Meaning of an Intangible Asset

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- Dictionary : Asset that is not physical in nature
- AS-26 : Identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
- Income tax Act : Section 2(11)(b) - Intangible assets, being know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature.

Meaning of an IPR in Commercial World

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- ❑ IP refers to creation of a human mind, i.e. invention, industrial designs for articles, literary & artistic work, symbols, etc. used in commerce.
- ❑ An IPR gets value when laws protect the creation of human mind.
- ❑ To be protectable, the IPR has to be reduced to a tangible form, which can be recognized.
- ❑ Valid IPR only when there are economic benefits in the form of exploitation by use or by transfer.

IPR's are increasing importance

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- Many reasons like global competition, high innovation risks, short product cycle, need for rapid changes in technology, high investments in R&D, production and marketing & more
- Commanding huge values & most of the time has value higher than the aggregate value of the other business assets.

Stages in the useful life of an IPR

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- Generally identified phases of an IPR lifecycle



- Discussion from Direct tax view from different phases of an IPR lifecycle.

I : Creation - Issues

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- Point of time when the IPR is created
- Cost of an IPR
- Determining the parameters for the both

As per AS-26, classify the generation of an asset in to
2 phases : 1) A Research phase
2) A Development phase

I : Creation - Issues

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- Expenditure on research – Recognize as an expense when incurred
- Expenditure on development – Recognize as an Intangible if the technical feasibility of creation is achieved & the persons developing it, have the confidence of completing the development of an Intangible & further use or sale of the same on commercial lines.

I : Creation – Location

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- Where actually the IPR is located?
 - Is it where the IPR is registered? OR
 - Where its owner is located? OR
 - Where it is exploited or used?
- By its intangible nature, IPR can be exploited in more than one jurisdiction/country simultaneously.
- Right to tax gains on its assignment would generally remain with the jurisdiction/country where the IPR is registered.

I : Creation – Location

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On the basis of judicial pronouncements & generally accepted methods, following are few types of IPR's & their location –

- Patents are deemed to be located where they are registered.
- Trademarks are located where they are registered.
CIT vs Finlay Mills Ltd (SC)
- Copy rights are located or situated where the rights are actually exercisable.

I : Creation – Location

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- ❑ Other intangibles are located where the owner is located.
- ❑ Some types of intangible assets are universal so do not have specific location.
- ❑ Technical know-how located at a place where the owner is located. [Pfizer Corp (AAR)]
- ❑ Trademarks & brand license are located where they have been in use & not where the owner is located. [Fosters Australia Ltd (AAR)]

I : Creation-Tax considerations in the hands of owner of the IPR

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- ❑ Current W/off Vs Future amortization.
- ❑ Matching costs & revenues
- ❑ Carry backward of losses not permissible in India
- ❑ Maximize current tax advantage on creation of an IPR.
- ❑ To locate the IPR in a suitable jurisdiction to take maximum advantage from tax, legal framework.
- ❑ To take maximum advantage of government grants, incentives, subsidies etc.
- ❑ Favorable future taxation for the income from IPR.
- ❑ Favorable entity status.

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I : Creation – Income tax Act

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Deduction of expenses on R&D

□ Section 35(1)(i) & 35(2)(ia)

Deduction available in respect of any revenue & capital exp (other than acquisition of land) incurred on scientific research related to business. Also any exp during 3 years preceding the year of commencement of business, on employees engaged in research or on purchase of material used in research.

I : Creation – Income tax Act

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Deduction of expenses on R&D

- Section 35(1)(ii), 35(1)(iii) & 35(2AA)

Weighted deduction of 175% for sum paid as contribution to specified approved entities for scientific research to be undertaken under a program approved by prescribed authority & Weighted deduction at 125% is allowed to any research association for research in social & statistical science.

I : Creation – Income tax Act

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Deduction of expenses on R&D

- Section 35(i)(iia) - Weighted deduction of 125% for payments to company registered in India having main object as scientific research & development.
- Section 35(2AB) - Weighted deduction of 200% in respect of revenue & capital exp (other than acquisition of land & building) for companies engaged in specified business of in house R&D approved by prescribed authority.

II: Sources of creation - Considerations

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- Internally/Self generated IPR.
- Cost of such Internally/Self generated IPR.
- Purchase of an IPR.
- Identify the IP that has been purchased to obtain maximum tax relief.

II : Acquisition - Valuation

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- Normally IP should be valued at actual cost (Purchase price, duties taxes & expenses directly attributable to making the IP ready for its intended use)
- Actual cost shall be adjusted subsequent to its acquisition on account of price adjustment, change in rate of taxes, foreign exchange fluctuations.
- Acquired in exchange of shares/other securities or other asset then IP shall be valued at fair value of the securities issued/other asset given up.

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II : Acquisition - Valuation

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- Acquired as a part of a group of asset for the consolidated price (Slump sale) then the consideration shall be apportioned to the IP based on its fair value.
- Acquired by way of government grant then to be valued as per AS 12 on Government grants.

Class of the IPR

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- Whether a Capital Asset OR Stock in trade ?
- If the Capital asset, then what is the date of acquisition? Is it the date of agreement or date on which the permission to exploit the right exclusively granted by the transferor ?
- Cost of Improvement
- Depreciation

III : Exploitation

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Ways in which IPR's can be exploited:

- Permission to use OR
- Transfer

III : Exploitation – Permission to use

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- ❑ Permission to use the IPR amounts to Royalty.
- ❑ In regard to payments of royalty to residents, the tax base is India.
- ❑ In case of payments to non-residents, the tax base may be India or deemed to be in India.
- ❑ Section 9 of the Income tax Act speaks about the Income is deemed to be accrue or arise in India
- ❑ Section 9(1)(vi) deals with the payments related to royalties.

III : Exploitation – Permission to use

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- Section 9(1)(vi)(b) - If a **royalty is payable by** a person who is **resident** in respect of any right, property or information used or for services utilized for the purpose of **business or profession** carried on by such a person **outside India** or for the purpose making or **earning** any income from any source **outside India**, it is **not taxable**.
- Issue : Is the exemption available when business is yet to be set up ?

III : Exploitation – Permission to use

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- Section 9(1)(vi)(c) - If a **royalty is payable by** a person who is **non-resident** in respect of any right, property or information used or for services utilized for the purpose of **business or profession** carried on by such person **in India** or for the purpose making or **earning** any income from any source **in India**, it is not taxable.

III : Exploitation – Permission to use

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- First proviso to Section 9(1)(vi) - Income by way of royalty as a **lump sum consideration for transfer outside India**, or imparting of education outside India in respect of any data, document, drawing or specification relating to any patent, Invention, model, design, secret formula or process or trademark or similar property, if such income is payable in pursuance of an **agreement made before 1st April 1976** & the agreement is **approved by CG**, is not taxable.

III : Exploitation – Permission to use

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- Second proviso to Section 9(1)(vi) - Income by way of **royalty of lump sum** payment made, by a person who is a **resident**, for the **transfer of all rights** including granting of license in respect of **computer software supplied by a non-resident manufacturer along with computer or computer based equipment under any scheme approved** under the policy on computer software export, software development & training 1986 of Government of India, is **not taxable**.

III : Exploitation – Permission to use

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As per Explanation 2 to Section 9(1)(vi) – Royalty means consideration (including lump sum but excluding consideration chargeable under the head Capital Gains) for–

- Transfer of all or any rights (including granting of a license)
- Imparting of any information concerning the working of or use of the IPR

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III : Exploitation – Permission to use

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- Use of an IPR
- Imparting of any information technical, industrial, commercial or scientific knowledge, experience or skill
- Use or right to use any industrial, commercial or scientific equipment except amounts referred in Section 44BB (Income in case of exploration of mineral oils)

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III : Exploitation – Permission to use

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- Transfer of all or any rights (including granting license) in connection with radio broadcasting but not including sale, distribution or exhibition of cinematographic films
- Rendering any service in respect of all the above.

III : Exploitation – Permission to use

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As per Explanation 5 to Section 9(1)(vi) – Royalty includes consideration in respect of any right, property or information, **whether or not** –

- The possession or control of such right etc is with the payer.
- Such right etc is used directly by the payer.
- The location of such right etc is in India.
- The explanation is for the removal of doubts.

Double Taxation Avoidance Agreement

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As per Article 12(2) of the OECD MC 2003. Royalty means :

- Payment 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 cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

DTAA : India - USA

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As per Article 12(3) of India – USA DTAA, royalty means :

- payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof ;

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DTAA : India - USA

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- payment of any kind received as consideration for the use of, or the right to use, the industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 or Article 8.

DTAA : India - UK

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As per Article 13 of India – UK DTAA, royalty means :

- payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work, including cinematograph films or work on films, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience;

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DTAA : India - UK

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- payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than income derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic.

IV : Disposal – Capital asset

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- As per the capital asset definition in Section 2(14), capital asset has all embracing connotations & includes every kind of property as generally understood except those that are expressly excluded from the definition.
- Hence on transfer of an IPR, Capital gains tax is payable at the rates applicable.
- Capital gains tax will depend on the period of holding the IP as it will be classified as Long term or Short term.

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IV : Disposal – Capital asset

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- If IP is internally generated, then the cost of acquisition will be NIL or could be small hence taxable capital gain will be higher.
- Cost of Improvements – possible to deduct from consideration received if it has increased the enduring benefits as determined initially.
- Indexation – Available
- Taxability on transfer will depend upon the location of the IP.

IV: Disposal – Other than Capital asset

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- Treatment in case of company which is engaged in the business of development of Research & Development, transfers the IPR created by them?

Considerations during the period of use

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- Allowability of depreciation
- IP must fall within the definition of Intangible.

III : Other Tax Considerations

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- If the payment is categorized as royalty, it is subject to withholding tax at applicable rates on gross basis. Thus the payer is required to withhold tax at the rates applicable on gross payments or credit whichever is earlier.

Tax considerations – Future challenges in taxation of IP

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- Identifying asset itself.
- Identifying location – difficulties in the age of modern technology.
- Identifying the cost where assets are created through global efforts.

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