

White Paper- Royalties and Licence Fees



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This paper contains a brief on Royalties and Licence Fees

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Royalties and Licence Fees - This paper looks at the levy of both customs duties and service tax on royalties and licence fees related to imported goods.

The “Make in India” campaign has put the spotlight on foreign presence in manufacturing in India. This typically involves an Indian subsidiary to which material is supplied from abroad, and to which know-how is transferred and licensed for use by the foreign parent. Technical know-how fees and royalties would be paid by the Indian arm in these arrangements.

These payments attract may liabilities of withholding tax (subject to the provisions of any double taxation avoidance agreement), customs duties and service tax. Herein we look at the provisions relating to customs duties and service tax.

Valuation of goods for customs purposes is governed by section 14 of the Customs Act 1962. Under this, the value of imported goods for customs is the transaction value:

“... the value of the imported goods and export goods shall be the transaction value of such goods, that is to say, the price actually paid or payable for the goods”, plus certain stipulated items:

“... such transaction value in the case of imported goods shall include, in addition to the price as aforesaid, any amount paid or payable for costs and services, including commissions and brokerage, engineering, design work, royalties and licence fees, costs of transportation to the place of importation, insurance, loading, unloading and handling charges to the extent and in the manner specified in the rules made in this behalf.”

Thus, in addition to the price of the goods, the value of the goods for customs will (inter alia) include royalties and licence fees, to the extent and in the manner specified in the rules made for the purpose. The rules made for the purpose are the Customs Valuation (Determination of the Price of Imported Goods) Rules 2007 (hereinafter referred to as the valuation rules).

In the valuation rules, rule 3 again reiterates the primacy of transaction value, plus certain costs and services:

“the value of imported goods shall be the transaction value adjusted in accordance with provisions of rule 10;”

Rule 10, in turn, provides as follows:

10. Cost and services. - (1) In determining the transaction value, there shall be added to the price actually paid or payable for the imported goods, –

- (a) ...
- (b) ...
- (c) royalties and licence fees related to the imported goods that the buyer is required to pay, directly or indirectly, as a condition of the sale of the goods being valued, to the extent that such royalties and fees are not included in the price actually paid or payable;
- (d) ...
- (e) All other payments actually made or to be made as a condition of sale of the imported goods, by the buyer to the seller or by the buyer to a third party to satisfy an obligation of the seller to the extent that such payments are not included in the price actually paid or payable.

Explanation - Where the royalty, licence fee or any other payment for a process, whether patented or otherwise, is includible referred to in clauses (c) and (e), such charges shall be added to the price actually paid or payable for the imported goods, notwithstanding the fact that such goods may be subjected to the said process after importation of such goods....”

From the above extracts of section 14, and rules 3 and 10 of the valuation rules, it is seen that

- Value of imported goods for customs purposes is transaction value (if there is no impediment to its acceptance), plus costs and services as per rule 10 of the valuation rules.
- Under rule 10 of the valuation rules, any royalties or licence fees that have to be paid as a condition of the sale of the goods, to the seller or to a third party, must form part of the value for customs.
- Royalty or licence fee, includible in value in terms of the above, will be included even if paid for a process to which the goods will be subjected post-importation.

As per rule 13 of the valuation rules, the said rules have to be understood in terms of the interpretative notes appended to them. Referring to these, we find two notes to rule 10(1)(c), which read as follows:

“Rule 10(l) (c)

1. The royalties and licence fees referred to in rule 10(l)(c) may include among other things, payments in respect to patents, trademarks and copyrights. However, the charges for the right to reproduce the imported goods in the country of importation shall not be added to the price actually paid or payable for the imported goods in determining the customs value.
2. Payments made by the buyer for the right to distribute or resell the imported goods shall not be added to the price actually paid or payable for the imported goods if such payments are not a condition of the sale for export to the country of importation of the imported goods.”

Thus, the interpretative note makes it clear that payments made for right to reproduce the imported goods in India will not form part of the value for customs. We have to infer that this will be the case even if the payments are made as a condition of import of the goods.

To sum up the position in customs law in respect of royalties and licence fees:

To form part of value for customs:

Royalties and licence fees paid as a condition of import of the goods, including such payments made for a process to be carried out on the goods after importation. An example of a case decided on this basis was the ruling dated 19 November 1996 of the Supreme Court in Civil Appeal number 3152-53 of 1991 of Essar Gujarat Limited, wherein the Court held that licence fee paid to a third party under the agreement with the seller of the goods was a condition of sale of the goods and formed part of the value for customs.

Excluded from value for customs:

Royalties and licence fees paid for reproduction of the goods in India after importation. (It may be noted that right to use software in various centres of the importer was held to be different from right to reproduce it, in the case of State Bank of India versus Collector of Customs, Civil Appeal number 2935 of 1996, decided by the Supreme Court on 11 January 2000.)

Service Tax

Service tax is levied under section 66B of the Finance Act 1994 (hereinafter, the Act) on service provided in the taxable territory (India minus Jammu & Kashmir). Thus, to be taxable, an activity

- Must be a service;
- Must be provided in the taxable territory.

“Service” is defined in section 65B (44) of the Act as something done for another person for a consideration. It does not include sale of goods, including deemed sale in sales tax law.

