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Tax Planning in India: Non-integrated principal structure, with variable royalty model

1. Ideally or hypothetically, in the case of a "classical or integrated principal structure" in the context of India,

   a. The principal company (PrincipalCo) would be located in a favourable jurisdiction, having marginal tax exposure. There would be two subsidiary companies in India, namely SubCo 1 and SubCo 2, for carrying out manufacturing and selling activities respectively.

   b. SubCo 1, being the manufacturer, would manufacture products for PrincipalCo under a contract manufacturing model, say with a profit margin of 5 to 6% on full cost.

   c. SubCo 1 would physically despatch the goods to SubCo 2 for distribution in India. The title of the goods would have moved from SubCo 1 to PrincipalCo; and then to SubCo 2, i.e. via abroad. Say, SubCo 2 would have retained a net profit margin of 3 to 4% on turnover, for distribution functions.

   d. Thus, the profits retained in India would be as follows, namely 5 to 6% on full cost for contract manufacturing; and 3 to 4% on turnover for distribution.

   e. The entrepreneurial profits, ideally relating to the intangibles in the form of technology and brand; and also strategic functions with respect to research and development (R&D), raw material procurement, namely setting quality parameters and specifications, selection of and negotiation with vendors, etc. would be parked with PrincipalCo.

   f. Thus, the entrepreneurial profits would have been guarded against the high effective tax rate in India of 48% [including dividend distribution tax @ 21%, duly factored in].

2. However, due to regulatory restrictions in foreign exchange dealings, it is not possible to implement a classical or integrated principal structure in India. The Indian regulatory authorities would not permit PrincipalCo to raise an invoice in foreign exchange on the distributor, i.e. SubCo 2, or any other Indian customer, and be paid in such foreign exchange, when the goods would not be imported from abroad, but move within India.

3. The way an MNC conventionally does business in India, is by setting up a subsidiary company [SubCo] as a licensed manufacturer, who manufactures and sells goods in India on its own account; and pays royalties for technology and brand. Currently, there is no cap or limit on the royalties, which may be remitted abroad.

4. Payment of routine royalties for intangibles might be insufficient portability of profits both from the economic and tax perspective, particularly where the profit margin in India could be quite high, say 20% of sales. Thus, under the plain vanilla licensed manufacturing model, the significant entrepreneurial profits would be trapped in India and taxed @ 48%.

5. One would need to develop a potent transfer pricing planning mechanism with respect to the "forced/ default" licensed manufacturing model, which would achieve more or less a similar economic result as that under the classical or integrated principal structure model, as referred to above.

6. Since, the revenues would be initially accounted for in the books of SubCo, the profit portability would need to be achieved through payment of bundled royalties for technology, brand, non-routine functions, etc., which may be coined as "industrial franchise fee".

7. The business of SubCo can be broken down into two divisions, namely – (a) manufacturing; and (b) distribution. The distribution division could function in the same way as SubCo 2 in the principal structure model, as explained earlier; and thus, earn profit margins of 3 to 4% on turnover.

8. It is true that the manufacturing division would not work as a contract manufacturer for PrincipalCo, but would work on account of the legal owner of the division, i.e. SubCo. However, except for the "form" of the transaction, all other aspects could more or less remain the same at the ends of PrincipalCo and SubCo, so far as manufacturing activities are concerned.

9. Thus, the license agreement for technology and trademark could be drawn up in a manner that :

   a. PrincipalCo, apart from being the licensor of technology and brand, would also provide significant non-routine and value added services in favour of SubCo for the efficient running of the business of SubCo.

   b. PrincipalCo would provide necessary assistance and guidance to SubCo in the matter of manufacture of the products, namely, quality and specification of raw materials, production scheduling, selection of and negotiation with vendors, etc.

   c. PrincipalCo would decide upon the marketing and sales promotion strategies for the entire region, including India. SubCo would implement the said marketing strategies for the Indian market.

10. Thus, for the limited manufacturing functions, the manufacturing division of SubCo would be entitled to routine profits, linked with either capital employed or costs, say 5 to 6% on full costs. Therefore, the total profit margin of SubCo would be, say, 3 to 4% on sales for distribution functions; and 5 to 6% on full costs for manufacturing functions, which would be more or less similar to the combined results of SubCo 2 and SubCo 1 under the principal structure model, as explained earlier.

11. The entrepreneurial profits in the system, being the balance amount of profits, namely after providing for the routine returns on account of manufacturing and distribution functions performed by SubCo, which would be attributable to the – (a) intangibles belonging to; and (b) significant non-routine and high value functions performed by PrincipalCo, would be repatriated as bundled royalties/ industrial franchisee fees by SubCo in favour of PrincipalCo.

12. In case SubCo also contributes to some unique local intangibles, being ideally marketing intangibles, created through strategic marketing and distribution functions; and the related expenses around advertisement, marketing and sales promotion, incurred by it, the residual or entrepreneurial profits, as referred to in paragraph (11) above, may be split between PrincipalCo and SubCo on an intelligible basis, in proportion to contribution of non-routine intangibles by the two parties, through the application of residual profit split method.

13. One would also need to carry out a study of royalty rates prevalent between third parties in similar industry segment, from global royalty databases. The said study would provide the basic comfort for the tax administration that the bundled royalty rate arrived at as per the split of profits referred to in paragraphs (11) and (12) above, is not exorbitant, given the type of industry segment, with which PrincipalCo and SubCo would be associated.

14. Thus, one would be able to achieve more or less similar results of a classical or integrated principal structure even under a “forced/ default” licensed manufacturing model, which may be coined as “non-integrated principal structure”.

15. The payment of bundled royalties or industrial franchise fee would attract withholding tax (WHT) in India @ 10%, which would be otherwise creditable in the country of PrincipalCo.

16. The said royalties/ fees would also attract input GST in the hands of SubCo under the reverse charge mechanism, however, the same would be creditable against SubCo’s liability towards GST on manufacture and sale of finished products, thus, without having any economic impact whatsoever.

17. We have obtained success in obtaining certainty for such “non-integrated principal structure”, with a variable royalty or industrial franchise fee model, by applying the residual profit split method, in the first ever bilateral advance pricing agreement (APA) signed between India and Switzerland. The APA team simultaneously resolved the issue of marketing intangibles in the hands of the Indian subsidiary (licensee) through the application of such residual profit split method for determining royalty, being also a first of its kind.

18. The aforesaid method resulted in considerably high royalties or industrial franchise fee in relation to the domestic turnover of the Indian subsidiary company, as per the facts and financials involved in such case.

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