Cross Border Taxation of Royalty and Fee for Technical Services - An India Update

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Preamble

- Fee for technical services (FTS) and Royalty arises because of commercialization of intellectual properties
- Non-residents are liable to tax in India on these income streams based on the “source rule”
- Determination of tax incidence involves:
  - Domestic law vis-à-vis applicable tax treaty
  - Choice of more beneficial provision
- Withholding tax implications - a crucial obligation

In today’s session we will be focusing on the India tax incidence for royalty/fee for technical services earned by non-residents

Structure of Discussion

1. Source Rule
2. Scope of levy
3. Tax Rates
4. Withholding tax obligation on payments to non-residents
   - > Recent Karnataka High Court Decision
5. Select Case Discussions
   - > Taxation of Software Payments
   - > Taxation of Database Subscription Fee
   - > Taxation of Server Hosting Charges
   - > Taxation of Telecommunication Charges
   - > Characterisation to be based on Main Services
6. Concluding Remarks

Proposal under the Direct Tax Code (DTC)

Emerging Issues

India's position on OECD views (July 2008 update)

Source Rule : When Does India have a right to tax the FTS/Royalty of the Non-resident?

Source Rule (domestic law)

- FTS/Royalty accrue or arise in India where it is:
  - Payable by the Government
  - Payable by resident unless it is payable in respect of any right, property or information used or services utilized:
    - for the purpose of or in the business or profession carried on by such resident outside India or
    - for the purpose of making or earning any income from any source outside India
  - Payable by non-resident only if it is payable in respect of any right, property or information used or services utilized:
    - for the purpose of or in the business or profession carried on by such non-resident in India or
    - for the purposes of making or earning any income from any source in India

DTC proposal – sourcing principle for FTS/Royalty taxation is similar but further emphasis on the fact that deeming provisions would apply though services are rendered outside India or the income has otherwise not accrued in India.

Source Rule (treaty)

- Treaty would provide India the right to tax the passive income streams provided the income arises in India
  - What arises in India? The interplay of domestic law
  - Typically treaty provides that the income is deemed to arise in India
    - if payer is resident in India; or
    - the income has a nexus to a Permanent Establishment / Fixed base in India [governed by Article 7/14]

Additional Comments

- Supreme Court has held that for income to be sourced in India the law envisages the fulfilment of two conditions for the service to be taxed in India, viz.: (a) such services are rendered in India, and (b) such services are utilised in India, and these two conditions have to be satisfied simultaneously. [Ishikawajima-Harima Heavy Industries Ltd. v. DIT]
  - Contrary views prevail subsequent to introduction of Explanation to Section 9 which provides that the income shall be deemed to accrue in India whether or not the non-resident has a residence or place of business or business connection in India

- CBDT on OECD Model: India reserves its right to tax royalties & FTS at source – it reserves the right to define with reference to domestic law and define source of such payment

What qualifies as Fee for Technical Services?

Scope of FTS (domestic law)

- Broad and exhaustive definition
  - rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel)
  - but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries" (Explanation 2 to Section 9 (1) (vii))

DTC proposes to include - development and transfer of a design, drawing, plan or software, or any other service of similar nature;

Scope of FTS (treaty)

- OECD model does not contain a FTS article

- India's treaty position on FTS can be categorized as follows:
  - Absence of Article on FTS.
  - Concurrent Coverage (i.e. FTS and Independent Personal Services)
  - Fee for Included Services (FIS)
  - Fee for Technical Services (FTS).
  - MFN clause in the treaty.

* Acknowledge Mr Pinakin Desai's presentation

Scope of FTS (treaty)

- Alternative 1 : Absence of Article on FTS
  - No special treatment for technical services
  - Tax incidence to be based on characterization as Business Profits/Other Income/IPS (if specified such as Brazil)
  - E.g. Mauritius, Philippines

- Alternative 2: Concurrent Coverage (i.e. FTS and Independent Personal Services)
  - Treaty has Article on Independent Personal Services; Treaty also has Article on FTS.
  - Usually, IPS ropes in fixed base and professional services: Individuals, Firms.
  - Example: Bulgaria, China
  - USA, UK treaties avoid the overlap.

Scope of FTS (treaty)

- Alternative 3: Fee for Included Services (deals with technical services)
  - Definition of FIS (Refer for example Indo - US Treaty)

    "For purposes of this article, "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services :

    - .....
    - make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a plan or technical design."
  - Under FIS Clause :
    - Service should be technical or consultancy; (plus)
    - Service should satisfy further condition as per the definition.
  - Service even if technical may not be FIS : such technical service fee is business income of recipient. Taxable in country of residence of non-resident enterprise.
  - Typically associated with service PE

Scope of FTS (treaty)

- Alternative 4: Fee for technical services
  - Treaty definition largely at par with Domestic Law
  - Treaty Definition : (Refer for example India-Japan Treaty).
    - "The term "Fees for technical services" as used in this Article means payment of any amount to any person ..... in consideration for the services of a managerial, technical or consultancy nature including the provisions of services of technical or other personnel.

- Alternative 5: Most Favoured Nation (MFN) protocol
  - MFN may restrict FTS to FIS – without consequential service PE trigger though cause treaty may have FIS with service PE
  - Examples of MFN clause: Treaties entered into by India with countries Belgium, France, Hungary, Israel, Spain, Sweden, and Switzerland

Additional Comments

- Distinguish technical service from technology driven service
- Treatment on export commission payable to non-resident agent
  - post withdrawal of Circular 23/1969 and 786/2000
  - Commercial or office or administrative services to be distinguished
  - What is the withholding obligation? - In light of the Karnataka HC decision in the context of Section 195;

What qualifies as Royalty

Scope of Royalty (domestic law)

- Domestic law has a comprehensive and exhaustive definition. It would encompass:
  - Transfer of ***rights*** in respect of the intellectual properties
  - Transfer of ***information*** on the working of the intellectual properties
  - ***Use*** of the intellectual properties
    - Physical use is not necessary . Deriving advantage by employing it would constitute use.
  - Imparting of know how
  - Equipment royalty w.e.f 01.04.2002
  - Transfer of rights in respect of any copyright, literary, artistic or scientific work
  - Rendering services in connection to above

- Intellectual properties
  - Patents
  - Inventions
  - Model
  - Design
  - Secret formula or process or trader mark or similar property

Proposal under Direct Tax Code

- The definition of the royalty under the proposed DTC is widened
- The word “secret” is now specifically restricted only to formula by inserting comma after the word formula
- The use or right to use ship or aircraft is specifically included in equipment royalty.
- The use or right to use transmission by satellite, cable, optic fibre or similar technology amounts to royalty. Accordingly, payments to satellite companies, data transmission charges are now considered as royalty.
- Transfer of all or any rights in respect of live coverage of an event is now considered as royalty.

Scope of Royalty (treaty)

Text	OECD model (Article 12(2))	UN model (Article 12(3))
- means payments 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,	✔	✔
- Or films or tapes used for radio or television broadcasting	X e.g. India treaty with Belgium, Sweden	✔ e.g. India treaty with US, UK,
- Any patent, trademark, design or model, plan, secret formula or process,	✔	✔
- Or for the use of, or the right to use, industrial, commercial or scientific equipment,	X e.g. India treaty with Belgium, Sweden	✔ e.g. India treaty with US, UK
- Or for information concerning industrial, commercial or scientific experience	✔	✔

We should specifically review definition under each applicable treaty before decision making

Additional Comments (CBDT view on OECD)

OECD POSITION	INDIA POSITION
Transfer of full ownership of an element of property referred in the definition “royalties” (Para 8.2)	
Payment not for use of or the right to use – hence not royalty- Article 7 / 13 to apply	May constitute royalty
Payment for obtaining exclusive territorial distribution rights of a product / service (Para 10.1)	
not royalty – payments to increase sales receipts – Article 7 to apply	May constitute royalty
Payment for the development of design , model or plan that does not already exist (Para 10.2)	
Not royalty – payments to create new design /model – Article 7 to apply	May constitute royalty
Act of copying programme for effective operation of programme by the user (Para 14)	
Not royalty – Article 7 to app	May constitute royalty

Additional Comments (CBDT view on OECD)

OECD POSITION	INDIA POSITION
Method of transferring the computer programme (Para 14.1)	
Not relevant – no royalty	May constitute royalty
Site licenses, Enterprise licenses, network licenses - Facilitating effective user – reproduction for other purposes restricted (Para 14.2) (Like multi user licences)	
No royalty – Article 7 to apply	May constitute royalty
Distribution intermediary – distribution of software copies (Para 14.4)	
No royalty – Article 7 to apply	May constitute royalty
Transfer of full ownership rights (Para 15 & Para 16)	
No royalty – Article 7/ Article 13 to apply	May constitute royalty
Downloading digital products for obtaining and using required data (Para 17.3)	
No royalty – Article 7 to apply	May constitute royalty

Tax Rates

Tax Rates for Royalty/FTS

Income pursuant to agreement after 1.06.05	Tax Rate	Applicable Section	Basis of Taxation	TDS Rate *	DTC Rates **
If effectively connected with PE or fixed place of profession even if Government approved or in accordance with industrial policy.	42.23%	44DA	Net	42.23%	20%
Not effectively connected with PE.					
• Approved by Government or in accordance with Industrial policy.	10.56%	115A	Gross	10.56%	20%
• Not covered by (i) above.	42.23%	S.28 r.w. amended S.44D	Net (?)	42.23%	20%
* The payer could opt for the rates under the relevant DTAA if beneficial ** Excluding surcharge and cess and on gross basis					

Select Case Discussions

WHT Obligation on payments to Non-Residents

- Remitter Company/Taxpayer was engaged in the import of shrink-wrapped software.
- No WHT under Section 195 was effected since it did not construe the payment to be in nature of royalty
- The A.O and the CIT (A) did not accept the claim of the remitter company and treated the remitters as “assessees in default” and sought to recover the taxes from them under section 201 of the Income Tax Act.
- On appeal, Bangalore ITAT agreed with the taxpayer’s position stating
  - that use of software, which is subject to a copyright, is different from the use of the copyright of such software. It was only a right to use a copy of the software, with the copyright retained by the developer of the software.
  - Consequentially the payment would not qualify as a royalty and thus should not be subject to the WHT.
- On further appeal by the Department, the Karnataka High Court held:

.....

WHT Obligation on payments to Non-Residents

- Placing reliance on the SC judgment in *Transmission Corporation* case, the HC Held:
  - a determination of final tax liability of the recipient is not called for the purposes of withholding under section 195 of the Act. The withholding under section 195 is only a tentative deduction and the rights of the recipient are not adversely affected. It is open to the recipient to demonstrate that no tax is payable in India on the sums which suffered tax withholding in India. Such an exercise can be done by way of filing a return of income in India and subjecting such a return to the process of assessment by the tax authorities.
  - there was absolutely no scope for the AO/CIT(A)/ITAT to embark on an exercise for determination of the tax liability of the non-resident recipient, in a proceeding under section 195 of the Act and even more so in a case where the resident payer had not even invoked the enabling provisions of section 195 [2] of the Act [prior ruling from an AO]
  - even under section 195(2) and 195(3) of the Act, when an application is made to the AO seeking concessions from the withholding liability, the scope of the AO is limited to what quantum or percentage of the payment will have to suffer withholding

WHT Obligation on payments to Non-Residents

- Emerging issues -
  - The HC has **not** opined on the characterization of software payments and the consequential tax incidence in India
  - Should tax be deducted on all payments to non-residents irrespective of the income being chargeable to tax in India?
  - Can treaty rate be adopted proactively or need prior AO approval under 195(2)?
    - Should be possible in light of rates in force definition (Section 2(37A)(iii)]
  - What if the remitter believes the payment is not FTS/Royalty? Should he deduct tax @ 40%?

As the HC stated -

" the obligation on the part of the resident payer who makes such a payment to the non-resident recipient is like a guided missile which gets itself attached to the target, the moment, the resident assessee makes payment to the non-resident recipient and there is no way of the resident payer avoiding the guided missile zeroing on the resident payer. The only limited way of either avoiding or warding off the guided missile is by the resident payer invoking the provisions of section 195 [2] of the Act and even here to the very limited extent"

Taxation of Software Payments

- Payments towards import of shrink-wrapped software should not qualify as a royalty
  - The incorporeal right to software i.e., copyright remains with the owner and the same is not transferred to the purchaser
  - The purchase could be for captive use or resale (there should be no reproduction rights) or embedded in a hardware

- Payments for development of a customized software
  - Is it Royalty? – transfer of know-how or provision of a service
  - India-US Memorandum to the treaty considers payment for computer software development as a FIS

- Select Judicial Precedent
  - Infrasoft Limited v. ADIT 2009 (28) SOT 179
  - Motorola Inc v. DCIT 2005 95 ITD 269
  - Samsung Electronics Co. Limited v. ITO 2005 276 ITR (AT) 1
  - Lucent Technologies Hindustan Ltd. v. ITO 2004 270 ITR (AT) 62
  - Sonata Information Technology Ltd. vs. ADDL. CIT [2006] 103 ITD 324 (BANG.)

Taxation of Database Subscription Fee

- The F Co maintains a "database" which is located outside India and which contains the financial and economic information including fundamental data of a large number of companies world-wide.
- The databases contain the published information collated, stored and displayed in an organized manner by F Co, though the information contained in the database is available in the public domain.
- The F Co through its database enables the customer to retrieve this publicly available information within a shorter span of time and in a focused manner. For a customer to access and view data, the customer needs to download client interface software (similar to internet browser). The customer can subscribe to specific database as per its requirement.
- F Co enters into a master client license agreement with its customers under which F Co grants limited, nonexclusive, non-transferable rights to use its databases, software tools, etc.
- The F Co states that it does not carry on its business operation in India and there is no agent in India acting on behalf of the F Co and having an authority to conclude the contracts.
- The F Co receives subscription fees from its customers and the same are received outside India.

Taxation of Database Subscription Fee

- Whether in making this centralized data available to the customer-licensee for a consideration, can it be said that any rights which FCo has as a holder of copyright in database are being parted in favour of the customer ?
  - No proprietary right and no exclusive right which FCo has, has been made over to the customer. The copyright or the proprietary rights over the "literary work" remains intact with FCo notwithstanding the fact that the right to view and make use of the data for internal purposes of the customer is conferred. Several restrictions are placed on the licensee
  - Licensee has a facility of viewing and taking copies for its own use without conferring any other rights available to a copyright holder.
- Is it imparting of information containing know-how?
  - In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public.

Taxation of Database Subscription Fee

- Is it sharing of information containing industrial, commercial or scientific experience?
  - the ‘experience’ mentioned should be one’s own experience in the realm of industrial, commercial and scientific and not compilation of somebody else’s experience. Further, such experience should give rise to some form of intellectual property rights.
- Can it brought within the purview of equipment royalty, i.e., "use" or "right to use" any industrial commercial or scientific equipment?
  - It is submitted that the server which maintains database is being used by customers as a point of interface. The consideration is not paid by the licensee for the use of equipment. The consideration is for availing of the facility of accessing the data/ information collected and collated by FCo.
- Select Judicial Precedent:
  - Factset Research Systems Inc AAR 2009 (317) ITR 169
  - Wipro Ltd. v Income Tax Officer 2004 2005 (278) ITR 57
  - Dun and Bradstreet Espana S.A v 2004 2004 272 ITR 99 (AAR)

Taxation of Server Hosting Charges

- The Indian Company is engaged in the business of setting up of websites for the purposes of E-Commerce. For hosting of the websites, the Indian Co required space of servers, which are not available in India at the relevant time. For this purpose the Indian Co takes space on servers and pays rentals to non resident entities.

- Installation and operation of sophisticated equipments with a view to earn income by allowing customers to avail of the benefit of the user of such equipment does not result in the provision of technical service to the customer for a fee. However as a passing reference the Delhi bench held that the same may qualify as Equipment Royalty, however since the same was not covered under the domestic law (for the relevant year) the transaction was held not to be taxable.
  - The equipment royalty clause was introduced with effect from only April 1, 2002. So what will be the position now?

- Select Judicial precedent
  - Millennium Infocom Technologies Limited v ACIT 2009 (309) ITR(AT) 18

- While OECD suggests server hosting fee do not qualify as royalty the Indian High Powered Committee report suggests otherwise

Taxation of Telecommunication Charges

- IndCo is a part of “Fo” Group engaged in the business of providing international long distance and domestic long distance telecommunication services in India.
- IndCo proposes to enter into an agreement with FCo, with a view to providing end to end international long distance telecommunication services to its Indian customers. Indian customers of Ind Co would transmit their voice/data to places outside India.
- IndCo would provide the Indian leg of the service by using its own network and equipment and network of other domestic operators and the international leg of the service would be provided by F Co using its international infrastructure and equipment.
- The network and equipment of F Co will not be used in India and the In Co's network and equipment will not be used outside India.
- In respect of the aforesaid services rendered by Fo Co, Ind Co will pay fees to the former.

Taxation of Telecommunication Charges

- Does the fee denote Equipment royalty i.e. the use or right to use the telecommunication infrastructure?
  - There is no use or right to use of equipment .
  - “Use” does not simply mean taking advantage of something or utilizing a facility; the term in the provision intends to denote that the person should operate or control the equipment

- Is the service a Technical Service?
  - The technical service in question does not make available technical knowledge, experience, skill, know-how or process, or consist of the development and transfer of a technical plan or technical design. No technical service is rendered and, secondly, there is no transfer of technology. It is well settled that telecom services are standard services.

Taxation of Telecommunication Charges

- Does the arrangement confer a right to use a process?
  - There is no use of any secret process; so held not royalty

    (Does it need to be a secret process? Each treaty / domestic law provision needs consideration)

- DTC proposes to charge these as Royalty

- Select Judicial Precedent:
  - Cable and Wireless Networks India Private Limited AAR 2009 (315) ITR 72
  - Dell International Services (India) Private Limited AAR 2008 (305) ITR 37
  - Wipro Limited v. ITO 2003 (80) TTJ 191

Characterisation to be based on Main Service

- USCo is engaged in providing service to hotels in various parts of the world. USCo enters into agreement with a IndCo engaged in the business of hotel.
- The scope of services envisaged in the agreement is publicity, advertisement and sales including reservation services and it allows the Indian Company to use its logo “S”.
- The tenure of the agreement is fixed at 10 years. In consideration of the services the Indian company agreed to pay a fee at the rate of 3% of the room sales to the F Co.
- Does the use of trademark or computerised reservation system trigger a royalty characterisation?
  - The main service rendered by USCo to its client-hotels is advertisement, publicity and sales promotion keeping in mind their mutual interest and, in that context,
    - the use of trademark, trade name or the stylized "S" or other enumerated services such as the computerized reservation system are incidental to the said main service.
  - The payments received are thus neither in the nature of royalty under domestic law / treaty

Characterisation to be based on Main Service

- Does the service qualify as FTS?
  - No under domestic law since there is no technical or consultancy service but activity comprises mere publicity, advertisement and sales promotion
  - No under tax treaty – since there is no technical knowledge made available
- Select Judicial Precedent
  - DIT v Sheraton International Inc 2009 (313) ITR 267

Concluding Remarks

Comments

- Recent treaties
  - DTAA with Serbia, Luxembourg, Myanmar
    - No separate clause on FTS in the treaty with Myanmar
- Other factors (not discussed today)
  - Beneficial ownership
  - Existence of a PE and the income attribution / expense allowability
  - Transfer pricing implications
- India appears to be adopting an aggressive tax policy in case of cross-border transactions and does not appear aligned with international principles of taxation
  - India's extensive reservations on the OECD views – where is the principle of e-neutrality?
  - Proposals under New Direct Tax Code
- The recent Karnataka HC decision casts a significant change in the position adopted by the industry vis-à-vis its WHT obligations

Thank you

"An organization's ability to learn, and translate that learning into action rapidly, is the ultimate competitive advantage"

- Jack Welch

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