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Course Material

M.A. (INTERNATIONAL TAXATION)

2.3.10. ROYALTIES AND FEES FOR TECHNICAL SERVICES

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Royalties and Fees for Technical Services

Module I – Royalties

1. Introduction

Royalty is generally a consideration received by a person - a creator or an innovator for allowing his work of art or scientific invention to be used commercially. But in commercial and industrial terms, the concept of Royalty is wider. Royalty is generally a payment received by the owner of an intangible right or know-how under license in any technology transfer. Such intangible rights are often for making use of intellectual property such as patents, inventions, models, secret formulae, processes, designs, trademarks, service marks, trade names, brand names, franchises, licenses, commercial or industrial know-how, copyrights, cultural activities, films or television rights, literary, artistic or scientific works, computer software, exclusivity rights, etc. Royalty essentially signifies payment for 'user right'. Such user right could be an annual payment or a pre-decided periodical payment.

Royalty has thus embedded in it the concept of rentals received as consideration for use of or the right to use any patent, trademark, design or model, plan, secret formula or process. Payment in the nature of royalty is quite different from payment in connection with outright sale. In outright sale, along with the property or right over it, the ownership is also transferred. In case of Royalty, the transferor retains the proprietary right in patent, trademark, design or model, plan, secret formula or process, but allows the use of such right etc.

As per the UNCTAD World Development Report 2011, Non-Equity Modes (NEM) of international production is of equal importance as that of Foreign Direct Investment (FDI). NEMs include a range of activities like contract manufacturing, services outsourcing, contract farming, franchising, licensing, management contracts and other types of contractual relationships. Through such relationships, MNCs can significantly influence the management of the enterprises of the host countries without participation in equity. Dissemination of knowledge, technology and skills are essential ingredients of such relationships. Naturally, the enterprises of the host nations will enter into royalty or technical services agreements with the foreign partners, necessitating outgo of licensing or technical services fees. The benefits to the host nations manifest in terms of employment, value added, export generation and acquisition of technical know-how.

Intellectual property rights are the rights given to persons over the creations of their minds. They usually give the creator an exclusive right over the use of his/her creation for a certain period of time. Intellectual property rights are customarily divided into two main areas:

(i) Copyright and rights related to copyright

The rights of authors of literary and artistic works (such as books and other writings, musical compositions, paintings, sculpture, computer programs and films) are protected by copyright, for a minimum period of 60 years after the death of the author. Also protected through copyright and related (sometimes referred to as "neighbouring") rights are the rights of performers (e.g. actors, singers and musicians), producers of phonograms (sound recordings) and broadcasting organizations. The main social purpose of protection of copyright and related rights is to encourage and reward creative work.

(ii) Industrial property

Industrial property can usefully be divided into two main areas:

a) One area can be characterized as the protection of distinctive signs, in particular trademarks (which distinguish the goods or services of one undertaking from those of other undertakings) and geographical indications (which identify a good as originating in a place where a given characteristic of the good is essentially attributable to its geographical origin). The protection of such distinctive signs aims to stimulate and ensure fair competition and to protect consumers, by enabling them to make informed choices between various goods and services. The protection may last indefinitely, provided the sign in question continues to be distinctive.
b) Other types of industrial property are protected primarily to stimulate innovation, design and the creation of technology. In this category fall inventions (protected by (patents), industrial designs and trade secrets.)
c) The social purpose is to provide protection for the results of investment in the development of new technology, thus giving the incentive and means to finance research and development activities. A functioning intellectual property regime should also facilitate the transfer of technology in the form of foreign direct investment, joint ventures and licensing. The protection is usually given for a finite term (typically 20 years in the case of patents).

While the basic social objectives of intellectual property protection are as outlined above, it should also be noted that the exclusive rights given are generally subject to a number of limitations and exceptions, aimed at fine-tuning the balance that has to be found between the legitimate interests of right holders and of users.

2. <u>Scope of Article 12</u>

The provisions of the Indian Income Tax Act, 1961 may not be the final determinant for determination of tax liability of a non-resident. If the provisions of the Treaty are more favorable to the taxpayer, the same would prevail. It is thus important to know about the provisions of Royalty and FTS in the Tax Treaties and their corresponding provisions in the Model Tax Conventions.

Countries often enter into tax treaties with each other to mitigate the effects of double taxation. Such tax treaties may cover income taxes, inheritance taxes; value added taxes, or other taxes. Most tax treaties:

(i) define which taxes are covered and who is a resident and eligible for benefits,
(ii) reduce the amounts of tax withheld from interest, dividends, and royalties paid by a resident of one country to residents of the other country,

(iii) limit tax of one country on business income of a resident of the other country to that income from a permanent establishment in the first country,
(iv) define circumstances in which income of individuals resident in one country will be taxed in the other country, including salary, self-employment, pension, and other income,
(v) provide for exemption of certain types of organizations or individuals, and
(vi) provide procedural frameworks for enforcement and dispute resolution.

Besides bilateral tax treaties, multilateral tax conventions are also often used as a guide for framing the tax treaties. In this context, it needs to be understood that tax treaties are normally bilateral as to tax is the sovereign right of a country. Thus, multilateral tax conventions act as guide only.

OECD countries have framed one such convention called, OECD Model Tax Convention on Income and on Capital, with focus on residence of the taxpayer. On the other hand, the UN Model Tax Convention has focus on source of income. Apart from the above, the US Tax Model is often referred to in tax literature.

The taxation of royalties is an issue that has more to do with the competition between capital-importing and capital-exporting countries in a global economy than it have with substantive legal implications. As a result of the shared taxation envisaged for royalties in many tax treaties, the scope of the definition of royalties varies depending on whether states concerned are considered to be technology-importing or technology-exporting countries. In this respect, countries that import technology and pay royalties are interested in a broad concept of royalties so that they can levy tax on more income at source. Conversely, countries that export technology and receive royalties defend a narrower concept of royalties so that the source country levies less tax on income. Consequently, the residence county would not have to grant relieve and would be able to exercise exclusive residence country taxation for this income, as the income would not be royalties subject to shared taxation, but, rather, business profits or independent personal services subject to exclusive taxation in the country of residence.

The two conventions - the OECD and the UN, provide for taxation of royalty income in Article 12. The OECD Convention and the US Model provide for taxation of royalty income in the state where person who beneficially owns the IPR is resident. In the UN Convention, the source (on income) state also has taxation rights, and the resident country may reserve its taxation right. Also, the tax is imposed by the source state at a pre-negotiated percentage of the gross amount. That apart, there are also differences in the definition of royalty itself in the two model tax conventions. It is seen that the OECD convention does not have any clause on equipment royalty, which is available in the UN Convention. Rentals for commercial and scientific equipment fall under the category of equipment royalty.

Since India is traditionally a net importer of technology and hence a payer of Royalty, it has followed the UN Model Convention in its negotiations with most of the countries.

As per definition given in OECD, royalties mean 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, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial commercial or scientific experience.

3. Source Rule or Allocation Rule [Article 12, Paragraph 1]

Article 12(1) states that royalties may be taxed in the country of residence of the beneficial owner even though derived from sources in the other Contracting State. This confirms Article 1(3) of the DTA that preserves the right of each country to tax its residents.

4. Difference between Copyright and Copyrighted Articles

The Copyright Act, 1957 protects original literary, dramatic, musical and artistic works and cinematograph films and sound recordings from unauthorized use. Copyright is a right given by the law to creators of literary, dramatic, musical and artistic works and producers of cinematograph films and sound recordings. It is a bundle of rights including, inter alia, rights of reproduction, communication to the public, adaptation and translation of the work. There could be slight variations in the composition of the rights depending on the work. Unlike the case with patents, copyright protects the expressions and not the ideas. There is no copyright for an idea but only to the expression of thoughts.

Works covered by copyright include, but are not limited to, literary works such as novels, poems and plays; reference works such as encyclopedias and dictionaries; databases; newspaper articles; films and TV programs; musical compositions; choreography; artistic works such as paintings, drawings, photographs and sculptures; architecture; and advertisements, maps and technical drawings. Copyright also protects computer programs.

The general rule is that a copyright lasts for 60 years. In the case of original literary, dramatic, musical and artistic works the 60-year period is counted from the year following the death of the author. In the case of cinematograph films, sound recordings, photographs, posthumous publications, anonymous and pseudonymous publications, works of government and works of international organizations, the 60-year period is counted from the date of publication.

Copyright is distinct from the material object, copyrighted. Copyright is an intangible incorporeal right in the nature of a privilege, quite independent of any material substance. Copyright or even right to use copyright is distinguishable from sale consideration paid for “copyrighted” article. This sale consideration is for purchase of goods and is not royalty.

The transfer of rights in or over copyright or the conferment of the right of use of copyright implies that the customer should acquire rights either in entirety or partially, co-extensive with the owner who divests himself of the copyrights that he possesses.

A non-exclusive and non-transferable license enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in the DTAA. The enjoyment of some or all the rights which the copyright owner has is necessary to invoke the royalty definition. The parting of intellectual property rights inherent in and attached to the software product in favour of the customer triggers royalty characterization under the DTAA.

Merely authorizing or enabling a customer to have the benefit of data or instructions contained therein without any further right to deal with them independently does not amount to transfer of rights in relation to copyright.

5. Royalty and Payment for Embedded Software

Embedded software is specialized programming in a chip or on firmware in an embedded device to controls its functions. Hardware makers use embedded software to control the functions of various hardware devices and systems.

In the case of ***CIT Vs Alcatel Lucent Canada***, Delhi High Court concluded that the income earned from the supply of hardware equipment where the embedded software facilitates the functioning of the equipment cannot be taxed as royalty payments for use of software because there could not be any independent use of such software.

In this case, the assessee was a France-based company engaged in manufacturing, trading and supply of equipments and services for GSM Cellular Radio Telephones Systems. The assessee had supplied software embedded in hardware equipments to its customers in India. Such software embodied process which was required to control and manage specific set of activities involved in the business of its customers. The AO reopened the assessment to tax the consideration received by assessee as royalty under Sec. 9(1)(vi) of the Act. The CIT(A) as well as tribunal held that supply of embedded software to the Indian customers not amount to royalty as per Sec. 9(1)(vii) and thus, not taxable in India.

Revenue was of the opinion that software licensed by the assessee contain the process which is required to control and manage the specific set of activities involved in the business use of its customers. Software also made available the process to its customers, who used it to carry out their business activities. Therefore, the consideration for supply of software amounted to royalty under Section 9(1)(vi) of the Act.

Whereas the assessee was of the opinion that it has supplied tangible property (hardware equipment in which software embedded) and the payment made by the cellular operator for acquiring such property cannot be regarded as a payment by way of royalty. Therefore, the income earned is not in nature of royalty and at the best it is general business income which cannot be taxed as assessee has no PE in India.

Delhi High Court finally concluded that the software that was loaded on the hardware did not have any independent existence. The software supply is an integral part of the GSM mobile telephone system and is used by the cellular operator for providing the telecommunication services to its customers. The embedded software facilitates the functioning of the hardware and is an integral part thereof. The court relied on the judgement of Hon'ble Supreme court in the case of Tata Consultancy Services vs. State of Andhra Pradesh wherein it was held by the Apex court that software which is incorporated on a media would be goods and therefore, liable to sales tax. By applying the ratio of this judgment the supply of embedded software is a pure sale on which no royalty can be earned by the assessee company.

6. Royalty and Business Profits

Royalty is paid with reference to production or sales — Rs. 5 per unit or 1 per cent of sale etc. It is generally paid for the user of intellectual property rights belonging to someone else, such as trademark, patent etc. Business profits, on the other hand, is conditional and based upon profits. The one agreeing to take a share of profits is more intimately involved in the running of an enterprise and is a risk taker at that, but the supplier of technology, who has no financial stakes in an enterprise, usually settles for less alluring, but steady and sure royalties.

Google India vs Income Tax Appellate Tribunal (ITAT)

The Income Tax Appellate Tribunal's (ITAT) ruling that Google India's payments to Google Ireland consisted of royalty payments on intellectual property, rather than business income, would appear to be flawed. Google India is an authorised distributor of the 'Adwords programme' to Indian advertisers by Google Ireland. Google India's stand is that it is a reseller of advertising space and that the income in question is business income. If the remittances are treated as business income, the tax department would have to establish the presence of a permanent establishment (PE) or business connection of Google Ireland in India, to charge tax.

The implication of the ITAT ruling is that transfer of business income from an Indian subsidiary to its foreign parent in a technology-intensive business is not possible, that use of the parent's technology in the Indian operations would characterise the payment as royalty, subject to withholding tax. By this logic, any payment by Amazon in India to its global parent would be royalty.

Income transferred by ICICI's Dubai operation to the Indian parent, as any foreign branch would make use of the bank's banking solutions. Tax authorities must distinguish between business income involving the use of technology and income derived from licensing of technology.

Characterisation of income has been a grey area, especially online. This is the reason that the equalisation levy or the so-called Google tax was brought in, in 2016 June, on online advertising payments to foreign entities without a PE in India. The 6% levy obviates the need to characterise income. It also serves the principle of neutrality in taxation, not to let foreign-based companies escape taxation while domestic ones are taxed. Tax, India must, but on fair terms.

7. Royalty and Software Related Payments

Computer software, or just software, is normally a collection of computer programs and related data that provide instructions to a computer, what to do and how to do it. In other words, software is a conceptual entity which is a set of computer programs, procedures, and associated documentation concerned with the operation of a data processing system. We can also say that software refers to one or more computer programs and data held in the storage of the computer for some purposes. In other words, software is a set of programs, procedures, algorithms and its documentation. Program software performs the function of the program it implements, either by directly providing instructions to the computer hardware or by serving as input to another piece of software. The term was coined to contrast to the old term hardware (meaning physical devices). In contrast to hardware, software is intangible, meaning it "cannot be touched" Sometimes the term includes data that has not traditionally been associated with computers, such as film, tapes, and records.

Payment for transfer of computer software is one of the most litigated issues under the Indian Income Tax laws. Payments to a non-resident can be in the form of business income, capital gains or royalties on the basis of facts and interpretations of law. Many times, the taxpayers tend to consider payment for transfer of computer software as business income, and in the absence of a Permanent Establishment to be outside the ambit of taxation. Tax Authorities, on the other hand, consider such payments as royalty. The principles found in the tax literature and judicial rulings are summarized below:

(i) The consideration for right to use the copyright in the software can be royalty or business income, depending on the terms of the contract whether the property in goods passed to the user or not. If it is outright sale, the payment would be business income in the hands of the non-resident (seller of the software). If the user has no ownership and only the right to use, the payment to the non-resident would be royalty. Variations in contracts or terms of sale can however complicate such distinction.

(ii) Some of the Court decisions as well as commentators also make distinction whether
   a. license fees is for customized software (made for suiting specific requirement of the user) or
   b. off-the-shelf software.

(iii) Distinction has also been seen in terms of whether the payer of license fees acquires the right to use the software alone or has the right to make copies and distribute it to the public. It is also important to consider whether the right of distribution is with or without rights of modification of the software. Many taxpayers rely on the Supreme Court Decision in the case of ***Tata Consultancy Services vrs State of Andhra Pradesh (271 ITR 401)*** in the case related to AP Sales Tax. In the said ruling, software was declared as 'goods'. On the basis of such observation, it is held that payments for procurement of goods cannot be royalty. It may however, be stated that the Supreme Court Decision was in the context of sales tax act.

OECD recognizes taxing right of the resident country, i.e. there is no taxing right for the source country. The OECD commentary specifically deals with the issue of software, recognizing the complexity of the issue.

If transferor retains the ownership right but allows the payee to reproduce and distribute the software to the public or to modify and publicly display the program, consideration of such type would be in the nature of royalty. If such permission is only limited in extent, the payment is not considered royalty. Any consideration which involves complete transfer of ownership, such transaction would be taxable as business profits or capital gains. The business income of the non-resident will taxable in the source country if the foreign enterprise has a Permanent Establishment (PE). Sometimes the transferee obtains rights to make multiple copies of the program for operation only within the enterprise. A payment under such arrangement is to be taxed as business profits.

Sometimes distributers make payment to the copyright holder to enable it to distribute copies of the program without right to reproduce the program. Consideration accruing to the owner would again be business profits. Transactions where a software house or a computer programmer agrees to supply information and ideas of the principles behind a particular program would be taxed as royalty.

Some Case Studies Related to Software

Sonata Software Ltd vs ITO (International Taxation) 6SOT700 (Bangalore) [2006]

In this case, the company imported some packaged software. Under the agreement with the supplier, the company distributed the packed software to the ultimate user. The Assessing Officer held such payment as royalty. The Commissioner (Appeals) confirmed the view of the Assessing Officer. On appeal, the Tribunal referred to the following:

(i) Where the transaction is acquisition of a shrink-wrapped software or off-the-shelf software, the transaction is one of purchase of goods and not payment of royalties.
(ii) The payment in the instant case was for purchase of a copyrighted article and not to acquire any copyright.
(iii) The receipt of the non-resident is in the nature of business income.
(iv) The payee does not have a Permanent Establishment in India and hence no business income accrues or arises in India.

The Tribunal also held that provisions of Section 195 are not applicable in this case.

Motorola Inc, Ericson Radio System AB & Nokia Corporation vs DCIT [96 TTJ 1 ITAT (SB) Delhi] [2005]

The Special Bench of the Delhi Income Tax Appellate Tribunal was constituted to adjudicate upon various tax issues in connection with transactions of foreign companies with the Indian cellular companies. Some of the Indian Companies were their own subsidiaries, direct or indirect. Among various tax issues, the Special Bench exaimined whether the payments in relation to software made to the foreign companies should be assessed as royalties. The Hon'ble Tribunal, after examining the provisions of the contracts, domestic law provisions and the DTAA concluded the following:

(i) in all the three cases, the payments for software cannot be separated from the payment on account of hardware;
(ii) the payments were on consideration of copyrighted articles and not copyrights as such; and
(iii) such payments cannot be taxed as royalty.

Microsoft Corporation vrs ADIT (1TA Nos 1331-1336 of ITAT) Delhi) [2010]

Microsoft Corporation, USA created a complex distribution channel involving US and singapore based entities for distribution of 'shrink wrapped software'. The entities denied tax liabilities in India on various grounds, such as, that sale of copyrighted products is not royalty but business profits; that such business profits cannot be taxable as there is no PE. In the views of the Assessing Officer, the end users required a further license even after acquiring the software. The user license clearly stated that the product was licensed and not sold. The license was protected both under the copyright law and the patent regulations.

The Tribunal held as follows:

(i) The income accruing to Microsoft for supply of software is royalty under Section 9(1)(vi) of the Act. It is taxable as a copyright in a computer programme, and it is also a literary/ scientific work. A computer program can also be termed as an invention or process. As the end users have made payments for transfer of rights (including granting of a license) in respect of copyright, patent, invention, process, literary or scientific work, the payment would be in the nature of royalty.

(ii) The definition of Royalty as per the domestic law and as per the DTAA is the same.

(iii) The ITAT observed that the view of the OECD commentary expressing that profits from supply of software are not royalty but are views of the Authors. Such views, in the opinion of the ITAT, cannot be regarded as court decisions or law. It was observed that a number of countries do not subscribe to such view.

(iv) The judgement of the oft-qoted Tata Consultancy case (271 ITR 401) was analysed at length. It was observed that the distinction between 'copyright' and 'copyrighted article' as per the Tata case does not have application income tax cases. The Tata case was concerned with provisions of a state sales tax. The case was not concerned with the issue whether transfer of copyrighted software can give rise to royalty. The Motorola (93 TTJ 1) case was found distinguishable on the ground that in that case, software supplied was part of hardware and had no independent use.

(v) The income received by the other companies, except one was held as royalties. The income of only one entity was found to be taxable as business profit through its PE.

Millennium IT Software (AAR)[2011]

The Sri Lanka based Software Company entered into a Software License Agreement with an Indian Company. Its software called 'licensed programme' was to be installed at the designated sites of the user. The owner was to also deploy its personnel for them to be trained by the employees of the licensee. The agreement also provided for payment of 'license maintenance fee'.

According to the applicant, it had only granted the user the right to make copies of the licensed programme to be installed on equipment only at designated sites of the licensee. No transfer of IPR (intellectual property right) is involved in the process. The applicant did not have any permanent establishment in India so that its income becomes chargeable to tax. On this basis, the applicant felt that the licensee was not required to deduct tax at source.

The Authority discussed in detail the provisions of the Act, the copyright law and the provisions of the DTAA. The Authority observed the following points in particular:

i) Under the Indian Copyright Law, computer programmes are literary works and entitled to copyright protection;
ii) In the instant case, though the source code is excluded from the preview of the agreement, the programme under license still contains the object code which is also copyright protected;
iii) Dictionary meaning of licensee is a person who has permission to do an act which without such permission would be unlawful;
iv) Any usage of the computer programme would have been unlawful once the Software Licensing Agreement is in place;

v) Therefore, the corresponding payment is for obtaining the right to use the copyright, and hence taxable as royalty.

8. <u>Royalty and Payments for Know-how</u>

Technical Know-how means all recorded and unrecorded information and knowledge relating to the design, development of production, installation and operation of the Product.

Royalty is generally considered as the consideration paid to the technical know-how. The Karnataka High Court held that the royalty paid for technical know-how or licence for manufacturing/sale is capital expenditure. The assessee, Telco Construction is a company engaged in the business of manufacture, purchase and sale of hydraulic excavators, loaders, mechanical shovels, cranes and spare parts thereof. The assessee filed its return of income for the Assessment Year 2008-09 declaring total income.

The assessee claimed deduction on account of payment of royalty made by it to M/s Hitachi Construction Machinery Company Private Limited, Japan at the rate of 1% of the net factory selling price to the extent of Rs. 91,06,005 under Section 37(1) of the Act. The aforesaid amount was paid for use of technical know-how and grant of rights for manufacture of Hitachi licence products, which included intellectual property. The issue raised in this case was whether the royalty payment for user of technical know-how and intellectual property rights along with the right to manufacture for a temporary period was required to be considered as revenue expenditure and to be allowed under Section 37(1) of the Act.

The other issue raised was whether the expenditure towards royalty was a capital expenditure as the user of rights by way of know-how, intellectual property had resulted in enduring benefit to the Appellant when there was no acquisition of any capital asset. The division bench consisting of Justice Alok Aradhe and Justice H. T. Nagendra Prasad observed the distinction between capital and revenue expenditure with reference to acquisition of technical information and know-how has been spelled out in various cases and the primary test to ascertain whether a expenditure is a capital expenditure or revenue expenditure is the same viz., enduring nature test, which means where the expenditure is incurred which gives enduring benefit, it will be treated as capital expenditure.

The court further clarified that the assessee is a joint venture company and under the agreement has been granted non-transferable licence to manufacture/ assemble the Hitachi licence products within the territory using technical know-how furnished by Hitachi and to sell otherwise dispose of the Hitachi licence products. The products shall be sold only under the trade/ brand name of Tata Hitachi. The court noted that even expiry of the 11 years from the date of commercial production, the assessee is entitled to continue the manufacture and sale of Hitachi licence products for the aforesaid term of the agreement.

"The assessee has incurred an expenditure which gives him enduring benefit, therefore, the same has to be treated as capital expenditure. The Assessing Officer as well as the tribunal rightly held that payment of royalty made by the assessee is a capital expenditure and is not a permissible deduction under Section 37(1) of the Act," the court said.

9. Definition of Know-how

Technical Know-how means all published or unpublished research, development information, technical data, designs, formulas, prototypes, samples, plans, specifications, methods, processes, systems, trade secrets, empirical data, computer programs and any other information or documentation related to the Technology and to the Intellectual Property, whether patentable or not patentable, and whether in written, machine readable, oral form or drawing, and which exists at the Effective Date.

Technical Know-how shall include all concepts, methods, devices and/or ideas directed or relating to the Inventions covered by the Licensed Patents or Licensed Patent Applications.

10. Know-how vs. Provision of Services

Provision of services means commercial activities whereby a party (hereinafter referred to as the service provider) is obliged to provide a service to another party and receive payment; the service-using party (hereinafter referred to as the customer) is obliged to pay to the service provider and use the service as agreed.

10.1. Provision of Services for Oil and Gas Company

Many non-resident companies are engaged in the oil or natural gas exploration business. Other Non-Resident entities may provide services to them. Whether such services will be covered by Section 44BB or will be taxable as Fees for Technical Services will depend on the facts of the case and the contents of the agreements. It is important to note that in cases that where

i) the service provider is a non-resident and it provides service to another non-resident oil exploration company;
ii) the service is in the nature of fees for technical services
    (a) for agreements prior to 1.4.2003, FTS will not be taxable under section 44D or 115A since the payer is neither government not an Indian concern (it is non-resident). The tax rate will be as per Finance Act or as per Treaty, whichever is less.
    (b) for agreements after 1.4.2003, for concerns having no Permanent Establishment in India, tax will not be computed under section 115A but tax rate as per the Finance Act should apply, since the payer is neither government nor Indian concern (it is non-resident). The tax rate will be as per Finance Act or as per Treaty, whichever is less.

(c) for agreements after 1.4.2003, for concerns which have Permanent Establishment In India, business profit will be computed in accordance with Section 44DA.

Many questions have been raised whether all the services provided to the oil or mineral exploration enterprises should be taxable under section 44D/ 44DA or section 44BB of the Act. In many cases, courts have held that since Section 44BB is a special section concerned with taxation of oil exploration companies, Section 44D/ 44DA will have no applicability. The Finance Act, 2010 amended both Sections 44DA and 44BB. The present law position is that for oil and mineral exploration companies, if the service is technical in nature, presumptive taxation under Section 44BB will not apply.

In the context of Section 44BB, the following decisions are important: ***Halliburton Offshore Services Inc [2008] 300 ITR 265***

It was held that presumptive profit is applicable on the gross receipts and not the income element. The Delhi ITAT decision in the case of Sedco Forex International Drilling Inc vrs Dy CIT 72 ITD 415 has also been reversed by the High Court in 214 CTR 192 (Uttarakhand)(2008)

11. Payment for Mixed Contracts

Mixed Contract means any customer, distributor, or similar contract with any third party to which any asset seller is a party prior to the closing date that provides for both

(i) sales of products or services of the business, and

(ii) sales of any product or service of any asset seller or any of its affiliates that is not part of the business.

12. Payments for Digital Products (Images, Sounds or Text)

The digital revolution arrived nonetheless and states have been busy figuring out how they can increase revenues by exploring taxation of the marketplace for digital products.

In 2011, the United States Congress weighed in with the Digital Goods and Services Tax Fairness Act of 2011, a federal attempt to prevent states from taxing digital goods in a manner inconsistent with a state's existing legal framework for applying sales tax. Although it has only been a short time since the Act was enacted, states currently taxing digital goods have not stepped outside the boundaries of existing sales tax rates or sought to impose taxes separate from existing sales taxes. The impact of the federal law may or may not be significant and on a practical level, it remains to be seen whether this federal law will have any real bearing on the taxation of digital goods.

Digital products are broadly construed in many formats. Our focus is on digital products includes:
(i) digital audio files — music and podcasts,
(ii) digital video files — television shows or movies, or
(iii) digital books, delivered electronically without physical media.

Many states make some allusion to digital goods in their body of legislative and administrative law. In addition, the Streamlined Sales Tax Governing Board has made the identifying and defining of digital products a cornerstone of their effort.

There are three categories of states' approaches in defining digital goods:
(i) States that specifically define digital goods on their books through their adoption of SST model legislation.
(ii) States that define digital goods through laws, regulations or informational documents, often relating digital goods to existing sales tax objects.
(iii) States that have not defined digital goods for sales tax purposes to any level of usefulness.

The digital economy makes up 15.5% of global GDP in 2021 and has grown two and a half times faster than global GDP over the past 15 years, according to the World Bank. Many of the largest digital goods and services companies are multinational, often headquartered in the United States and operating internationally. There are significant differences in corporate tax rates between countries, and multinational companies can legally use base erosion and profit shifting (BEPS) to report their profits against intellectual property held in low tax jurisdictions (tax havens) to reduce their corporation tax liabilities. This has led to many new legal and regulatory considerations. In the field of international taxation, there has been debate about whether the current rules are appropriate in the modern global economy, especially regarding the allocation of income and profits among countries and the effect of this on taxes paid in each country.

Almost 50 jurisdictions have made changes in their current legislation regarding the taxation to include the digital tax, or presented new laws focused on taxation of digital economy.

In 2013, the Organization for Economic Cooperation and Development (OECD) began a project to examine base erosion and profit shifting (BEPS) of multinational companies (MNCs), with aim to create a single set of consensus-based international tax rules. In 2015, G20 Finance Ministers agreed a series of recommendations for setting minimum standards in national tax systems, revising international standards for the way those systems interlock, and promoting best practices. Under the auspices of the G20, an interim report was made in March 2018. In June 2019, G20 Finance Ministers agreed proposals drawn up by the OECD to find a consensus-based solution by the end of 2020. Later that year, the OECD launched a two-part consultation: first, proposals for determining where tax should be paid and on what basis ('nexus'), as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located ('profit allocation'); and, second, a proposal for a 'global minimum corporate tax level'. In October 2020, the OECD announced that it expects an agreement by mid-2021. The agreement was endorsed by the G7 Finance Ministers in June 2021.

In the meantime, several countries led first by the European Union have begun to propose and implement digital services taxes (DSTs) which have a number of aims: to raise tax revenues; to put pressure on other countries – in particular the United States – to reach an agreement; and, arguably, to create a level playing field until the OECD/G20 framework reaches an agreement or comes into force. Public debate in many countries has asked whether Big Tech companies are paying too little tax.

These national DSTs are mainly aimed at a small number of large digital companies that meet a worldwide revenue threshold and a domestic taxable sales threshold. In practice, most of these companies have their headquarters in the United States. The DSTs that have been proposed or implemented have similar characteristics and almost all were announced to be temporary measures. They are a mix of gross receipts taxes and transaction taxes that apply at rates ranging from 1.5% to 7.5% on receipts from the sale of advertising space, provision of digital intermediary services such as the operation of online marketplaces, and the sale of data collected from users. The attribution of revenue to a jurisdiction is generally based on whether the taxed service is viewed or enjoyed by a consumer on a device located in the jurisdiction based on its IP address or another geolocation method. Some countries have adopted various exemptions to the DST, including for payment services, digital content, and intragroup services.

Digital services taxes have been criticized for a number of reasons including: distorting market behavior by discriminating primarily against large U.S. MNCs and therefore providing a relative advantage to other countries' businesses that fall below the revenue threshold; taxing a business input that will likely be passed on to consumers (even though some jurisdictions, like France, have stated that consumers should not absorb the tax, several companies have already announced that they would increase their prices because of these DSTs); and, lack of harmonization in the application of these taxes which may result in double taxation if, for example, two or more countries tax the same revenue stream.

12.1. Digital Taxation in United States

In the United States, taxation of digital goods is partially governed by a federal statute and has been the area of significant state legislative and rule-making activity. States initially were slow to enact taxes on downloads, but with recent downturns in tax revenue caused by consumers purchasing more digital downloads, many states have sought ways to impose taxes on purely digital transactions. There are multiple ways that downloads are taxed.

Some states use their existing franchise, sales, and use taxes to tax purchases/uses/transactions of consumers of Internet goods and services. Other states enacted laws specifically aimed at digital downloads.

In 1997, the United States federal government decided to limit taxation of Internet activity for a period of time. The Internet Tax Freedom Act (ITFA) prohibits taxes on Internet access, which is defined as a service that allows users access to content, information, email or other services offered over the Internet and may include access to proprietary content, information, and other services as part of a package offered to customers. The Act has exceptions for taxes levied before the statute was written and for sales taxes on online purchases of physical goods.

The statute has been amended three times since its enactment to extend this prohibition. The first amendment solely extended the Act's duration. The second extended it again and clarified the definition of Internet access as including certain telecommunication services, as well as reorganizing sections within the Act. The third amendment again extended the prohibition but narrowed the definition of Internet access to "not include voice, audio or video programming, or other products and services ... that utilize Internet protocol ... and for which there is a charge" except those related to a homepage, email, instant messaging, video clips, and personal storage capacity.

In 2009, Anna Eshoo, Congresswoman from California's 14th District (which includes most of Silicon Valley), introduced a bill to make the Act permanent in its most recent permutation. However, this bill died in committee.

States levying a tax on digital goods may be violating the ITFA. The states using their original tax code may fall within the grandfather clause of the ITFA, but there has been no litigation to clarify this or other aspects of the Act. One of the few cases brought under the ITFA involved Community Telecable of Seattle suing the city of Seattle in Washington state court, where Telecable claimed it should not have to pay a telephone utility tax because it was an Internet access provider under the ITFA. The Washington State Supreme Court held that Telecable could not be taxed as a telephone provider when it was providing Internet access under the ITFA.

Every digital-specific tax created by a state has been enacted after the ITFA became law. These laws may be preempted because the ITFA bars taxes on Internet access, and multiple or discriminatory taxes on electronic commerce. Courts have yet to clarify whether the existing laws compound taxes or are discriminatory, although it is likely that these laws can survive scrutiny under the ITFA because they can be interpreted to only tax services that fit within the exception to Internet access described in the statute and to be the only taxes on these digital products. On the other hand, there may be problems with these taxes because they may cover products and services dealing with homepages, email, personal storage, or video clips.

Without litigation, it may be difficult to distinguish the difference between the definitions of content given by the ITFA, such as between a video clip and video programming. iTunes, for example, could be designated as video programming for the videos it sells based on the definition found in the federal statute regulating cable companies, and as video clips for its previews. These laws may also run into trouble if they tax a download that is already taxed by another state, because multiple taxes are defined as taxing property that has been taxed once before by another state or political subdivision.

Another possible federal limitation on Internet taxation is the United States Supreme Court case, Quill Corp. v. North Dakota, 504 U.S. 298 (1992), which held that under the dormant commerce clause, goods purchased through mail order cannot be subject to a state's sales tax unless the vendor has a substantial nexus with the state levying the tax. The dormant commerce clause could also apply to any efforts to tax downloads. Since most downloads are from companies that are centralized in a small number of states, it is likely that there will not be many states with a substantial nexus to download providers. At present, no litigation has arisen to determine what will be defined as a proper nexus for a distributor of digital content within a state. It is possible that a state would argue that servers are enough of a nexus to tax the content passing through, although the Supreme Court has already ruled that communication by common carrier is not enough to form a substantial nexus.

12.2. Digital Taxation in Canada

While the OECD has agreed on a common approach to tax digital companies, no treaty has been implemented yet to enforce it. Consequently, Canada has proposed to enact its own digital service tax. The plan has met opposition from the United States Trade Representative's office.

12.3. European Union on Digital Taxation

The EU operates Value Added Tax (VAT) and electronic goods and services are subject to VAT at the applicable rate. Each member state may set its own rate of VAT if they want. VAT regulations are very complicated and the intent of this article is not to provide definitive guidance but rather to list some of the relevant factors.

If a business is located within an EU member state and its turnover through internet sales or otherwise exceeds that member state's VAT threshold then the business must register for VAT. It is then obliged to collect VAT on its sales (outputs) and remit it to the tax authorities having deducted the VAT it pays on its purchases (inputs). If a business makes sales of physical goods to a member state that exceeds that member states distance selling threshold (typically either €30,000 or €100,000), then it must register to pay VAT in that member state and collect VAT at that member state's VAT rate. If sales are below the distance selling threshold, VAT must be collected at the VAT rate in the business' own member state.

If a business is located within an EU member state and supplies e-services to an individual who is not VAT registered in another EU member state then VAT rules of the state where the business is located apply. If the business supplies e-services to a VAT-registered individual in another state then the business is not obliged to pay VAT in its state and thus the individual must pay VAT in its state. If the business supplies e-services to a VAT-registered individual yet the individual receives the e-services in a state where neither the business nor the individual has their establishment then the business is obliged to register for VAT in the state where the e-services are delivered to. The 2015 EU VAT legislation requires two non-conflicting pieces of evidence to be produced so as to determine what VAT rate should be applied to these digital goods sales.

A business must always charge VAT to non-VAT registered entities (i.e. consumers) but should not charge VAT to foreign EU VAT registered businesses. These foreign EU businesses are required to declare their purchase and the tax due to their own tax authorities. In 2018, the European Commission (EC) proposed a temporary Digital Services Tax (DST) to be imposed at a rate of 3% on revenues derived from online advertising services, receipts or income from digital intermediary activities, and sales of user-collected data. The proposed tax would cover businesses with annual worldwide revenues exceeding $915 million (€750 million), and taxable revenues within the EU exceeding $61 million (€50 million). The initial EC proposal was rejected at the EU level.

12.4. Digital Taxation in India

India implemented an Equalization Levy. The threshold of the expanded equalization levy in India is lower than in other countries. Non-resident businesses must comply with the levy if they have taxable gross receipts above INR 20 million ($260,000). India did not state that the Levy would only be a temporary measure.

12.5. Digital Taxation in Singapore

Singapore was the first state in its region to consider implementing digital tax into its tax system. The idea was revealed in February 2018 and the according bill passed by the parliament of Singapore in November of the same year to come in effect on 1 January 2020. The main reasoning behind this was explained by the Singapore Finance Minister Heng Swee Keat who said during his speech about budget in 2018: "Today, services such as consultancy and marketing purchased from overseas suppliers are not subject to GST. Local consumers also do not pay GST when they download apps and music from overseas. This change will ensure that imported and local services are accorded the same treatment." It is estimated that implementing of the digital tax will bring Singapore US$65.5 million per year. The implemented tax will be at the same level as the GST (Goods and Services

Tax) rate nowadays in Singapore, which is 7%, but it is important to notice that there is planned increase of GST rate at some point between 2021 and 2025.

12.6. Digital Taxation in Malaysia

Following Singapore, Malaysia was the second to make step towards implementing of the digital tax into its legislation system, as announced by Malaysia's Deputy Finance Minister Datuk Amiruddin Hamzah in November 2018. The tax rate will be introduced at level of 6% which is one of the lowest digital tax rates in the world. For comparison, Russia has 18%, Norway has 25% and New Zealand has 15%. The digital tax in Malaysia will come in effect on 1 January 2020.

12.7. Digital Taxation in Argentina

A digital tax in Argentina was announced in October 2017. It was specified that non-residents supplying digital services to customers in Argentina will be taxed 21% rate. The law is effective since June 2018. Argentina has a unique approach to collecting this tax. Usually, the collecting and remittance of VAT is liability of the non-resident supplier; in Argentina the tax is charged through the customers' credit cards used to pay for online services.

13. Force of Attraction on Outbound Royalties Effectively Connected to a PE (Article 12, Paragraph 3)

Article 12 provides that the royalties arising in the Source Country and beneficially owned by a resident of the Resident Country shall be taxable only in the Resident Country. The Model adopts the principle of exclusive taxation of royalties in the State of the beneficial owner's residence and admits only one exception at Article 12 with respect to the force of attraction on outbound royalties effectively connected to a PE. This is one of the few situations in which the Model prevents double taxation by attributing an exclusive right to tax to only one of the Contracting States, by using the expression royalties 'shall be taxable only' in the Resident Country, thereby precluding other Contracting States from taxing. In spite of the principle of exclusive taxation of royalties in the Resident Country adopted in the Model, many countries adopt a treaty clause (similar to that adopted for dividends and interest by the Model) that also attributes taxing rights to the Source Country, so that an intermediate approach has been adopted, according to which royalties may be taxed in the Resident Country, but the Source Country maintains the right to impose a tax. The Source Country is, however, free to give up all taxation on royalties paid to non-residents, but if the Source Country decides to tax outbound royalties its exercise of this right is limited by a capped relief to be attributed by the Resident Country for the tax charged in the Source Country.

14. Arm's Length Rule for Royalties (Article 12, Paragraph 4)

As per Paragraph 4 of Article 12 where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this convention.

OECD Transfer Pricing Guidelines, 2010, outlines various factors that require special consideration to apply arm's length standard of controlled transactions involving royalty payments. These factors include, the comparability of transactions; expected benefits from intangible property; limitations of the geographic area in which the rights may be exercised; capital investment; start-up expenses; development work required; possibility of sub-licensing; distribution network of the licensee and right of participation in further developments by the licensor.

Taxpayer may apply comparable uncontrolled price (CUP) method to determine arm's length royalty rate if owner of intangible asset has granted similar licensing rights to independent parties. But when internal comparable are not available, the royalty rate can be imputed by comparing the transaction under consideration with other transactions involving similar licenses and making appropriate adjustments for differences in conditions and terms of contracts. The cost plus method may also be used in some cases if proper comparable are available. However, when traditional transaction methods cannot be applied the taxpayer can rely on profit methods. The Transactional Net Margin Method (TNMM) is most common method applied in such situation. When net margins of comparable entities at transactional level are not available, the taxpayer may have no choice except to apply TNMM at entity level and then account for differences in transactions making appropriate adjustments. Similarly when intangible property is of unique nature or of high value for which comparables are not available, the profit split or TNMM can be applied.

The Mumbai Tribunal in Dow Agro Science ruling held that where Transfer Pricing Officer having found that royalty paid by assessee to its Associated Enterprise was higher as compared to similar payment made by another AE, added certain amount to assessee's Arm's Length Price, in view of fact that assessee had paid royalty on net sales of product whereas other Associated Enterprise made payment on gross sales receipts, there being difference in mode of computation of royalty, impugned addition was to be set aside. Similarly it was held in Kansai Nerolac Paint by Mumbai Tribunal. The Hyderabad Tribunal in RAK Ceramics held that where Transfer Pricing Officer had not even brought a single comparable to justify arm's length percentage of royalty either under CUP or TNMM, approach of TPO in estimating royalty at 2 per cent as against 3 per cent as claimed by assessee being in complete violation of Transfer Pricing provisions had to be struck down.

15. Royalty Income under Sec. 9(1)(vi)

Royalties arise from commercialization of intellectual property rights. Though Royalties and Fees for Technical Services (FTS) are often seen together in tax books as proverbial twins, there are some key differences between the two.

While Royalty is associated with IPR, Fee for Technical Services is mostly associated with rendering of managerial, technical or consultancy services. The differences are more apparent if we consider what constitutes Royalties or FTS as per Tax Laws. The tax law in India (the Income Tax Act, 1961) contains extensive provisions in respect of taxation of both - Royalty and Fees for Technical Services. These are provided in Section 9 of the Income Tax Act.

Royalty under the Indian Income Tax act, 1961 is defined under Section 9 of the Act. This section provides that consideration flowing in from the following items fall under the category of royalty:

a. the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
b. the imparting of any information concerning the working of or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
c. the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;
d. the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
e. the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;
f. the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or
g. the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Such payments can be in the form of a regular payment (such as monthly or quarterly) or can be one time lump-sum payment or a combination of the two but such payment even if any lump sum consideration should not be such that it qualifies to be the income chargeable under the head “Capital gains”. This would mean that it should not be a sale or transfer through which the person transferring it revokes its right to use it again.

The Income-tax Act also excludes the following from the purview of being considered as payment for royalty:

- Consideration for sale, distribution or exhibition of cinematographic film; and
- Consideration from the transfer of an IPR, which can qualify to be an income under the head “income from capital gains”.

Section 9(1)(vi) states the following income shall be deemed to accrue or arise in India:-

Income by way of royalty payable by

(a) the Government; or

(b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Provided that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum consideration for the transfer outside India of or the imparting of information outside India in respect of any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, if such income is payable in pursuance of an agreement made before the 1st day of April, 1976 and the agreement is approved by the Central Government.

Provided further that nothing contained in this clause shall apply in relation to so much of the income be way of royalty as consists of lump sum payment made by a person, who is a resident, for the transfer of all or any rights (including the granting of a licence) in respect of computer software supplied by a non-resident manufacturer along with a computer or computer based equipment under any scheme approved under the Policy on Computer Software Export, Software Development and Training, 1986 of the Government of India.

For the purposes of the first proviso, an agreement made on or after the 1st day of April, 1976, shall be deemed to have been made before that date if the agreement is made in accordance with proposals approved by the Central Government before that date; so, however, that, where the recipient of the income by way of royalty is a foreign company, the agreement shall not be deemed to have been made before that date unless, before the expiry of the time allowed under sub section (1) or sub section (2) of section 139 (Whether fixed originally or on extension) for furnishing the return of income for the assessment year commencing on the 1st day of April, 1977 or the assessment year in respect of which such income first becomes chargeable to tax under this Act, whichever assessment year is later, the company exercises an option by furnishing a declaration in writing to the Assessing Officer (such option being final for that assessment year and for every subsequent assessment year) that the agreement may be regarded as an agreement made before the 1st day of April, 1976.

For the purposes of this clause, “computer software” means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data.

Test Your Knowledge

QUESTIONS	
1.	An Indian distributor has made payment of royalty to a Japanese Film company. The royalty is on account of the 'right to exhibit an animation film'. The Japanese company retains the ownership so that the transaction is not one of capital gain or outright sale. Now, the definition of royalty under the Income Tax Act does not include the consideration for exhibition of cinematographic films. However, the India- Japan DTAA definition of royalty includes consideration for the 'use of, or right to use, any copyright of literary, artistic or scientific work including cinematographic films'. Will the consideration in question be taxable in view of such inclusion in the treaty?
2.	An Indian firm makes payment to a US Company for the right to use customized software as 'license fee'. The definition of royalty as per the Income Tax Act does not specifically mention consideration for software. Also, as per the facts, a treaty is not a taxing statue. On that logic, does it mean that such payment should be taxed as royalty?
3.	For Royalty or FTS, is surcharge applicable over and above the rate of tax specified in a treaty?
4.	The branch of a Sweden based company located in India makes a payment to its parent office for the right to use scientific equipment. It is assumed that in the facts and circumstances of the case, the payment cannot fall under any other category such as payment for use of or right to use a patent, invention, model etc. Find whether such payment is taxable as royalty.
5.	A Company entered into a Software License Agreement with an Indian Company. Its software called 'licensed programme' was to be installed at the designated sites of the user. The owner was to also deploy its personnel for them to be trained by the employees of the licensee. The agreement also provided for payment of 'license maintenance fee'. Analyse whether such tax will be deducted on such income?

	SOLUTIONS
1.	Royalty income of a non-resident is taxable in India as per ‘pay rule’. However, in the instant case, the receipt is not royalty as per definition of the act. The receipt is also not a business income since (i) no sale of the right has taken place or, in the alternative, (ii) prima facie, there is no ‘business connection’ of the Japanese company in India as per provision of Section 9 (1)(i) of the Act. Therefore, the item will not be taxable as royalty even if the treaty provision stipulates such receipt as royalty. It is altogether a different question to analyse and find out the place of accrual of the Income in the instant case under the full facts and circumstances of the case. If the income is found to accrue in India, though it is not royalty or business income, it can be taxed under the domestic act as ‘income from other source’.
2.	The definition of royalty as per the Income Tax Act, among others, include ‘consideration for the transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work, etc. The domestic act definition is wide enough to cover licensee fee payable for customized software. Therefore, the premise that license fee for customized software is not taxable as per the act is not correct.
3.	Under the Income Tax Act, for any special rate of tax (on capital gains, royalty income under Section 115A etc.), the tax computed is to be increased by applying surcharge and education cess, etc. The definition of tax in the treaties is however, ‘all in one type’. Therefore, no additional surcharge and education cess is to be applied over the treaty rate. In other words, for special rates specified in the treaty, presumably, the surcharge and education cess etc. are already included in the rate. However, for other types of income like business income etc. which are assessed according to the domestic tax law, the tax once computed applying the rate table, will have to be increased by surcharge and education cess.
4.	On the basis of the domestic law provision, such payment is in the nature of ‘equipment royalty’. However, the definition of royalty as per India-Sweden DTAA does not cover ‘equipment royalty’. The treaty provision being more favourable to the non-resident will prevail. It is also important that in this instant case, it is not possible to explore the taxability of the sum as ‘Income from other sources’. The logic is as follows: The income is taxable as royalty as per the domestic Act

	a) The receipt does not have the character of royalty as per Article 13 of the India -Sweden DTAA. b) It is not taxable as 'other income' in the treaty. This is because, Article 22, dealing with other income, is applicable only in respect of items of income which are not dealt with in any other article in the convention. Article 12 of the convention has specifically dealt with income of the nature under consideration.
5.	The case given in above question is similar to the case of ***Millennium IT Software (AAR)[2011]*** According to the applicant in this case, it had only granted the user the right to make copies of the licensed programme to be installed on equipment only at designated sites of the licensee. No transfer of IPR (intellectual property right) is involved in the process. The applicant did not have any permanent establishment in India so that its income becomes chargeable to tax. On this basis, the applicant felt that the licensee was not required to deduct tax at source. The Authority discussed in detail the provisions of the Act, the copyright law and the provisions of the DTAA. The Authority observed the following points in particular: i. Under the Indian Copyright Law, computer programmes are literary works and entitled to copyright protection; ii. In the instant case, though the source code is excluded from the preview of the agreement, the programme under license still contains the object code which is also copyright protected; iii. Dictionary meaning of licensee is a person who has permission to do an act which without such permission would be unlawful; iv. Any usage of the computer programme would have been unlawful once the Software Licensing Agreement is in place; v. Therefore, the corresponding payment is for obtaining the right to use the copyright, and hence taxable as royalty.

Royalties and Fees for Technical Services

Module II – Fees for Technical Services

16. Introduction

The taxation of technical services has also become very critical in view-of increased cross-border flow of services, high value of the transactions and deductibility of tax in the source country. Sometimes, the recipient of the services can also constitute a source. The characterization of Fees for Technical Services (FTS) income has thus become challenging. The taxpayers often declare FTS as business income claiming it as non-taxable in absence of PE.

It may be of interest to know how Fees for Technical Services are taxed in other parts of the world. 'Fees for Technical Services' are generally not defined in the taxation laws of most of the domestic laws of the other states. It may be taxed as business income or independent personal service in the states where the services are rendered.

Fees for technical services include consideration for managerial services, technical services, consultancy, provision of services of technical or other personnel.

Managerial services means the provision of assistance to establish or improve management systems in such areas as personnel, training, inventory control, production, strategic planning, purchasing, distribution, facilities design and information systems related to a business start–up or expansion.

The term 'technical services' takes within its sweep services which would require the expertise in technology or special skill or knowledge relating to the field of technology. As per the concise oxford dictionary, the term 'technical services' means belonging or relating to art, science, profession or occupation involving mechanical arts and applied sciences.

Consulting Services means the provision of expertise or strategic advice that is presented for consideration and decision-making. A Non-consulting Service Provider is an individual or a company who contracts to provide services, other than consulting services to another individual or business.

17. Scope of Fees for Technical Services under the DTAAs

In some DTAAs (such as those with Bangladesh, Brazil, Greece, Indonesia, Mauritius, Myanmar, Nepal, Philippines, Namibia, Saudi Arabia, Sri Lanka, Syria, Tajikistan, UAE, UAR Egypt and Zambia, etc.) there is no specific clause relating to FTS/ FIS (Fees for Included Services). The absence of the provision in the DTAA is not an omission but is a deliberate mutual agreement between the Contracting States not to recognize/classify any income as Fees for Technical Services for taxation. Once the income chargeable to tax as per the DTAA are categorized by excluding the FTS, then the scope of taxing the said income as FTS cannot be expended by importing the said provision from the Income-tax

Act when it is excluded under the DTAA. This is the end of the road for taxability in the source state.

Some of the DTAAs which India has entered into (US, UK, Canada, Australia, Finland, Singapore, etc.) provide for a restrictive definition (i.e., “make available” criteria) of the term “FTS”/“FIS”. Here, the term ‘make available’ means that the person acquiring the technical service is enabled to independently apply the technology. Thus, where the recipient of technical services does not get equipped with the knowledge or expertise and the recipient would not be able to apply it in future independently without support from the service provider, it will not be a case of technical service having been ‘made available’.

The AAR in case of ***Lanka Hydraulic Institute Limited [2011] (AAR)*** (unreported) has taken a contrary view and held that if such income does not cover under FTS/FIS, it would be covered within the ambit of the Article dealing with “Other Income” as opposed to the Article dealing with “Business Profits”. But Hon’ble SC in case of ***Ishikawajima-Harima Heavy Industries Ltd v DIT [2007](288 ITR 408)(SC)*** has cleared that in situations where a specific tax treatment is provided for “royalties” and “FTS” (in terms of a separate Article in the DTAA), other generic Articles (like the Article dealing with “Business Profits”) should not as such apply to the income dealt with by the specific Article.

Fig: Tax Treatment of FTS as per the Provisions of DTAA

18. Definition of FTS

Consideration for rendering of any technical or consultancy services, if such services:

(i) Ancillary and subsidiary to the application enjoyment of the right, property or information,
(ii) Make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of technical plan or technical design.

The OECD Model Convention and the US Draft Treaty do not contain the concept of FTS. It normally forms part of article on 'business profits' (Article 7). But most of the treaties which India has entered into provide for source country taxation of FTS. In simple terms, if the source of such income is from India, then the overseas service provider has to suffer Indian withholding tax.

FTS is widely defined to include payments towards technical, managerial and consultancy services. Generally, Royalty and FTS are contained in Article 12 or Article 13 of a tax treaty of India. In some of the treaties, the definition of Royalty may be in line with the UN model, but the definition of FTS may be more restrictive than the definition provided for in the Income-Tax Act, 1961 in treaties with the US, the UK and Singapore. The restrictive nature of the definition is due to the concept of 'make available' that is not found in the Indian Tax Law.

19. Fees for Technical Services and Business Profits

The issue for consideration is whether to treat the income from technical services as "business profits" or "fee for technical services" (FTS). Whereas business profits of foreign companies are taxable at the rate of 40 per cent (plus surcharge and education cess), FTS is generally taxed at the rate of 10 per cent. Hence, prima-facie, it appears that the assessee would like to treat his income as FTS.

In this context, an important fact which must be considered is that FTS is taxed at the gross amount of revenue, but in case of business profits, expenses are allowed to be deducted from gross revenue. Due to this fact, sometimes it is more beneficial for the assessee to treat the receipts as business profits instead of FTS.

A simple arithmetical calculation will show that if the expenses of the enterprise are more than 75 per cent of the gross amount, then it would be beneficial for the assessee to treat the receipts as business profits instead of FTS.

The ITAT Mumbai in the case of **Mckinsey Business Consultants Vs. DDIT** held that if there is no clause in DTAA to tax fees for technical services (FTS), then the same is taxable as business profits provided the income is earned by assessee through a PE in India.

Further, such income cannot be taxed as FTS under the provisions of Act because the residuary clause of India-Greece DTAA does not allow the incomes earned in ordinary course of business to be checked with Income-tax Act, it is only residuary incomes which need to be checked under the Act that too when DTAA is silent.

The facts of above mentioned case are as follows:

The assessee is a foreign company incorporated in Greece providing assistance in the form of borrowed service to its associate concern (McKinsey India) in consideration for which, the assessee received an amount from the Indian company. The said income was not offered to tax by the assessee in the return on the ground that the said income was earned in the course of business of the assessee and, therefore, it qualified as business profits under Article 3 of India-Greece DTAA. Since the assessee did not have any permanent establishment (PE) in India, its income was not liable to be taxed in India. The Assessing Officer observed that in view of the findings given in the assessment orders for the earlier years of the group entities, the said amount was to be taxed as fees for technical services (FTS) within meaning of section 9(1)(vii) and also under the provisions of India-Greece DTAA. DRP confirmed the order of AO to tax the consideration as Fees for Technical Services on the ground that since the DTAA is silent on FTS, provision of Act shall apply.

Assessee was of the opinion that there is no FTS clause in the India-Greece DTAA and therefore, such an income being earned in the ordinary course of business is business profits as per Article 3 of India-Greece DTAA. Business profits can taxed in India only when foreign company is carrying on business in India through a PE which is not so in the present case.

Whereas the revenue supported the order of DRP that merely because the treaty is silent on a particular type of income would not automatically qualify as business profits. In such a case, the provision of Income Tax Act need to be checked and income to be taxed under the item which is most specific cover the case excluded by DTAA. Such a view is also in line with Article 17 of treaty which provides that the cases not covered by DTAA would be governed by domestic law. Thus, the services rendered by the assessee company are clearly taxable as 'fees for technical services' u/s 9(1)(vii).

The ITAT Mumbai held that:

(i) The point of dispute is that whether consideration for rendering of services is taxable in India as fees for technical services (FTS) in the absence of FTS clause in India-Greece DTAA.
(ii) ITAT held that in absence of FTS clause in the India-Greece DTAA, the fees received by the assessee the fees cannot be treated as FTS and the same to be treated as business profits in the absence of India-Greece DTAA.

(iii) ITAT relied on the decision of its own decision in the case of Mckinsey (Thailand) wherein it was held that if the income is earned in the ordinary course of business it would be business profits unless in DTAA it is specifically treated as other income.
(iv) Thus, in the present case, since the clause of FTS is missing in DTAA, the possibility of taxing income as FTS have been ruled out and such income taxable as business profits only.
(v) Since the resident assessee company does not have PE in India its business profits cannot be taxed in India.

20. "Make Available" Concept

Article 13 of the UK-India Tax Treaty defines FTS as "payments for technical or consultancy services which are connected to any payment in the nature of royalty. Another category of services, which 'make available' technical knowledge, experience, skill, or knowhow or process, or services that consist of the development and transfer of a technical plan or design also fall into this category." Article 12(4)(b) of India-US tax treaty defines FTS to inter alia include "payments in consideration for the rendering of any technical or consultancy services, which make available technical knowledge, experience, skill, know-how or process."

Hence, as per this definition, services result in FTS only if they "make available" technical knowledge, experience etc. Fundamentally, a technology is `made available' when the person acquiring the services. The mere fact that the services have some technical aspects does not mean that technology is made available.

According to the memorandum of understanding (MoU) to the India-US tax treaty, technology is "made available" when the service recipient is enabled to apply the technology. The MoU provides illustrations. For instance, a US resident (X) "makes available" technical knowledge, skill, etc. to an Indian resident (Y), when X sends its experts to India to show Y's engineers how to produce an extra strong wall board, or when X modifies Y's formulas pertaining to oil refining process, to eliminate cholesterol in refined oil and trains Y's employees in applying these new formulas.

However, advising on marketing strategies or production on a job work basis are not services which make available technology, skills, etc. This MoU was referred to by the Authority for Advance Rulings in one case (AAR) (242 ITR 208). A US resident company (A) had deputed employees to its Indian group company (B) for rendering services (related to general management, finance, purchase, marketing and assembly/manufacturing activities). B had an irrevocable right to use, disclose and practice without any restrictions, all inventions, ideas and improvements made by A's employees. The AAR held that such services make available technical knowledge, experience and skills. Not only was there a transfer of information, but B was also conferred the right to use and disclose such technology and knowledge.

The Mumbai Tribunal in the case of **Raymond Limited v DCIT (86 ITD 791)** also referred to the MoU. The Tribunal held that services rendered by a UK lead manager in managing a GDR issue does not make available any technical knowledge, skill, experience, etc. The Tribunal observed that services could be considered as "making available" technical knowledge, experience, when the recipient is able to make use of the technical knowledge by himself in his own business or for his own benefit and without recourse to the service provider in the future.

There are contrary decisions also. The Delhi Tribunal in the case of **ITO v Sinar Mas (85 TTJ 794)** held that vetting of an existing project report by a reputed consultant (to enable the service recipient to raise finances) results in FTS under Article 12(4)(b) of India-Singapore tax treaty. However, the Calcutta Tribunal in CESC Limited (80 TTJ 8o6) held that opining and review of project details per se does not result in FTS under Article 13(4)(c) of India-UK tax treaty. Article 13(4)(c) could be attracted only if suggestions based on technical appraisal, knowledge and skill are ultimately adopted by the service recipient. In rendering its decision the Calcutta Tribunal referred to the Memorandum of Undertaking to the India-US tax treaty.

Some decisions where services were considered as having been "made available" are **Sahara Airlines Ltd v DCIT (83 ITD II) (Del)** and **Hindalco Industries v ACIT (94 TTJ 944) (Mum)**. The AAR in a case reported in (100 Taxman 206) also took a similar view. On the other hand, in the case of **Airports Authority of India v DIT (273 ITR 437) (AAR)** and **NQA Quality Systems v DCIT (92 TTJ 946) (Del)** it was held that technical knowledge, skills, were not made available by the service provider. A perusal of the judicial precedents indicates that there are some divergences of views. This controversy will subsist only when an authoritative ruling is pronounced.

21. <u>Income from Fees for Technical Services under Sec. 9(1)(vii)</u>

Section 9(i)(vi)/(vii) of the Act deem royalty/FTS to accrue or arise in India where it is:

(i) Payable by the Government

(ii) Payable by resident unless it is payable in respect of any right, property or information used or services utilized:
   a) for the purpose of or in the business or profession carried on by such resident outside India or
   b) for the purpose of making or earning any income from any source outside India

(iii) Payable by non-resident only if it is payable in respect of any right, property or information used or services utilized:
   a) for the purpose of or in the business or profession carried on by such non-resident in India or
   b) for the purposes of making or earning any income from any source in India.

Effect of the decision of the Hon'ble Supreme Court in the Ishikawajima-Harima Heavy Industries' case vis-a-vis the source rule

The decision of the Honourable Supreme Court in the **Ishikawajima-Harima Heavy Industries'** case (288 ITR 408) gave some direction to the source rule of taxing Royalty and FTS. The salient points of the ruling were:

- Offshore services to be regarded as accruing in India whether rendered in India as well as used in India.
- There must be sufficient territorial nexus to warrant imposition of tax.
- Explanation to section 9 was inserted by Finance Act, 2007 with retrospective effect from 1st June 1976.
- The amendment was to protect the source rule.
- The amended version states that Royalty/FTS deemed to accrue or arise in India shall be included in the total income of a non-resident whether or not the non-resident has a residence or place of business or business connection in India.
- Amendment in definition of FTS by the Finance Act 2010:

  The Finance Act, 2010 has amended the explanation relating to deemed accrual of Royalty and Fees for Technical Services. The pre-amendment explanation provided that in cases of deemed accrual of income of certain kinds including Royalty and FTS, such income is deemed to accrue or arise even if the non-resident does not have any residence or place of business or business connection in India.

  The above amendment has further clarified that in respect of FTS, the income shall be deemed to accrue or arise in India irrespective of the fact that the non-resident might not have rendered any service in India. The amendment has been made in the wake of a few judicial pronouncements regarding FTS. Such judicial decisions held that no income can be deemed in India if service is rendered outside India.

22. Definition of Fees for Technical Services under the Income-tax Act, 1961

Fees for Technical Services (FTS) have been defined in Section 9 itself under clause (vii) as any consideration (including lump sum) for rendering of any managerial, technical or professional services including the services of technical or other personnel. However, considerations for assembly, mining or similar project undertaken by the recipient have been taken out of the ambit of the definition of FTS. Similarly if any sum is received by a non-resident technician is chargeable to tax as salaries, the receipt cannot be taxable as FTS.

Following are not in the nature of FTS:

(i) Consideration for any construction, assembly, and mining or like project.

(ii) Salary received by a person in connection with providing technical service.

22.1 Basis of Taxation of Fees for Technical Services for Non-residents

A number of foreign companies or other non-resident entities run their business in India. Their income straightway are accrued or received in India. In some other cases, the income though not straightway accrued or received in India, may be deemed to accrue or deemed to be received in India. Whatever is the case, if the earning of the foreign entity is for providing technical services, the payer of such Fees for Technical Services generally enter into some agreements with the foreign entity. The payer or recipient of the technical service may be the government or any other Indian concern. If the agreement is an eligible one, such income is taxed at a lower, preferential tax rate.

Fees for Technical Services for non-residents are taxable in India if sourced in India. Apart from payments which are obviously taxable, there are still other situations where FTS are taken to be taxable, on the premise that is sourced in India.

23. <u>Withholding tax on FTS and Royalty under Sec. 194J</u>

The provisions of section 194J are as follows:

(i) TDS on fees for technical services will be deducted at 2%,
(ii) TDS on royalty for sale, distribution or exhibition of cinematographic films will be deducted at 2%, and
(iii) Individuals or HUFs having total sales or gross receipts or turnover exceeding Rs. 1 crore from business or Rs. 50 lakhs from profession in last financial year, will be liable to deduct tax at source from payment or credit, whichever is earlier, made in nature of professional fees (other than exclusively for personal purposes) or technical services.

With effect from 14th May, 2020, rates of TDS under various provisions are reduced by 25% till 31st March, 2021. Accordingly, rates of TDS and limits covered under amended section 194J as applicable for financial year 2020-21 are as under:

Amount paid or credited as –	**Limit above which TDS is applicable (Rs.)**	**Rate of TDS applicable from**	
		1st April to 13th May	**14th May to 31st March**
FPS	30,000	10%	7.50%
FTS	30,000	2%	1.50%
Royalty for sale, distribution or exhibition of cinematographic films	30,000	2%	1.50%
Other Royalty		10%	7.50%

In nature specified in section 28(va)	30,000	10%	7.50%
Payment to Director (not in nature of salary)	No limit	10%	7.50%
In case payee is only carrying on business of Call Centre	As mention above for respective nature	2%	1.50%

23.1 Differentiation between FPS and FTS

(i) As per explanation (a) to section 194J, fees for professional service means –

‘services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or advertising or such other profession as is notified by the Board for the purposes of section 44AA or of this section.’

(ii) As per explanation (b) to the said section, “fees for technical services” shall have the same meaning as in Explanation 2 to clause (vii) of sub-section (1) of section 9 which is as under –

‘any consideration (including any lump sum consideration) for the 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”.’

In view of the above, by interpreting the strict language of the section, it can be derived that ‘technical consultancy’ would fall under FPS whereas ‘technical or managerial or consultancy services’ would fall under FTS. Accordingly going to the micro part of the topic, the nature of transaction, involving technical aspect, categorise either as consultancy or as service, will determine whether consideration paid is FPS or FTS and in view of that rate of TDS will be 10 % or 2 % respectively.

23.2 Differentiation between Consultancy and Service

The terms ‘consultancy’ and ‘service’ are not specifically defined under the Income Tax Act, 1961. In many cases, the meaning is derived in various judgements by courts and tribunals.

Few of the known judgements are mentioned hereunder:

(i) GVK Industries Ltd. [2015] 371 ITR 453 (SC)

(ii) Le Passage to India Tours & Travel (P) Ltd. [2014] 369 ITR 109
(iii) E-bay International AG vs ADIT (2012) 25 taxmann.com 500 (Mum)
(iv) Intertek Testing Services India (P) Ltd. [2008] 307 ITR 418 (AAR)

On summarising observations from above judgements, meaning of terms ‘consultancy’ and ‘service’ can be defined as follows:

Consultancy: It involves giving an advice/ opinion/ recommendation or counselling having an element of expertise or special knowledge on part of the advisor.
Service: It means any activity carried out by a person for another.

Accordingly, it can be derived that in case consideration is paid or payable for transaction where there is involvement of only technical advice or opinion, then the same can be construed as FPS liable to TDS at 10% and however, if there is element of any (physical) activity by the technical person, then such transaction be construed as FTS.

For instance, say Mr. A, a technical person, gives advice over call or in person to Mr. B regarding whether the latter shall obtain a feasibility or project report from any technical person, by explaining benefits of such report and also discussing parameters to be taken care in such process, in respect of Mr. B’s project.

Accordingly, the consideration which will be paid by Mr. B to Mr. A would categorise for technical consultancy and FPS, liable to TDS at 10%. In similar case, if Mr. A prepares a feasibility or project report for Mr. B’s project, then it will involve activity carried out by Mr. A. Thus, the consideration will be for technical service categorise as FTS, liable to 2% TDS.

On the basis of above analysis, a fine line of difference is required to be derived for each transaction which is liable to TDS under section 194J. Further, sometimes it will be difficult to explain such difference between ‘technical consultancy’ and ‘technical service’ to assessing officers specifically in era of e-assessments wherein skill of tax professionals in reply drafting will always be pertinent.

The explanation furnished in the memorandum by the Finance Ministry regarding modification of rate of TDS on FTS to 2% from 10% is mentioned to reduce litigation among assessees and tax authority arsing due to misclassification of nature of transaction falling under section 194C (rate of TDS being 2% or 1%) and FTS liable to TDS at 10% under section 194J.

However, in process to reduce perplexity between classification of transactions liable to TDS under section 194C or section 194J being FTS, the amendment has resulted in ignition of spark of dispute with-in section 194J.

24 Some Case Studies Relevant to Fees for Technical Services

Skycell Communications Limited vrs DCIT [251 ITR53] 2001 (Mad)

This decision is in the context of liability to deduct tax at source under Section 194J of the Income-tax Act. As per this section, entities other than individuals and Hindu Undivided Families (HUF) should deduct tax at source from the fees for technical services payable to any resident. Though this decision is in connection with Section 194J, it is also equally applicable for liability to deduct tax under Section 195 of the Income Tax Act.

The facts of this case were that the assessee and a few other entities were in the business of providing cellular mobile services. They were collecting fees from the customers for various kinds of cellular services they had been proving. The department was of the view that the fees received/receivable by the cellular operators are in the nature of fees for technical services and the payers should have deducted tax at source.

The Madras High Court did not concur with this view. The Hon'ble High Court ruled that mere usage of technical equipment does not make a service technical. It was observed that in the instant case, no technical service is offered by the cellular operators.

CIT vrs Bharti Cellular Limited (Delhi) 330 ITR 239 (SC)

Though the issue involved in this case was of domestic taxation but the ruling has implication for international taxation as well. M/s Bharti Cellular Ltd. and other appellants are companies engaged in the business of providing cellular telephone facilities to the subscribers. The licenses were obtained from the Department of Telecommunications (DoT). The appellants were to set up their own equipments and infrastructure for operating and maintaining their network. However, if calls are made by their subscribers from their network to other network (MTNL/BSNL/any other private operator), such calls are to be routed through MTNL/BSNL. For the purpose of providing such interconnections, by virtue of agreements regulated by the TRAI, the applicants were to pay interconnection charges, access charges and port charges to MTNL/BSNL.

The Department was of the opinion that the appellants should have deducted tax at source from the connectivity and other charges payable to MTNL/BSNL. The Hon'ble High Court observed that (i) The expression 'Fees for Technical Services' as appearing in Section 194J is similar to the definition of the term in Section 9(1)(vii) of the Act. (ii) The word 'technical' has to be read along with 'managerial' and 'consultancy services'. Both 'managerial' and consultancy services involve some human element. The word technical as appearing in the expression should also have some human element. In the present case, there is no human interface. Therefore, it cannot be said that there is technical service. When the Department went against the ruling of the High Court to the Supreme Court, the Hon'ble Supreme Court remanded the matter back to the Assessing Officer (ITO/AC TDS) to examine, with the help of technical evidence, whether there is any human intervention in the processes involved. Apparently, the view of the courts seems to be aligned to the concept that some human intervention is a must for the service to be 'technical'.

G. V. K. Industries & Another vs Commissioner of Income Tax & Another 228 ITR 564 (Andhra) [1997]

The assessee, an Indian Company, was in the business of generation and sellling electricity. It constructed and erected a power generating station. It engaged M/s NRC, a non-resident consultancy firm for obtaining advice in the form of preparation of raising finance for the company. The High Court analyzed the facts and the documents involved and came to the conclusion that the income of the assessee cannot be considered as business profits. As per the facts of the case, the services of the non-resident was held to be consultancy and managerial in nature. The assessee maintained that the non-resident company only rendered advice in connection with procurement of loans which cannot be termed as technical or consultancy services. The court further held that the advice to strengthen finances is as much a technical or consultancy services as it would have been any technical or consultancy services with regard to management, generation of power or plant and machinery. The 'success fees' earned by the non resident was categorized as fees for technical services.

Cargo Community Network 289 ITR 355 (AAR) [2007]

The non-resident company based in Singapore hosted a portal and provided access to an air cargo portal. Indian booking agents paid fees for cargo booking and related services like subscription fee, system connection fees and help desk support fees. Help desk services were provided by the Indian Liaison Office located in India. The payments made by the Cargo Agents in India were in consideration of use of the portal developed by the non-resident company and hosted in its server at Singapore. The portal was displayed in the computer screen of the agent in India.

The AAR concluded that server and portal together constitute equipment. The equipment, the Authority observed, was used in India. In the facts of the case, the payment was held as equipment royalty. The AAR in this case also held that the definition of Royalty and Fees for Technical Services in the domestic Act is similar to their definitions in the India Singapore treaty.

Gmp International GmbH (AAR) 229 CTR 133 [2010]

In the facts of the case, the assessee was engaged as a consultant for drawing and design services for the new Tamil Nadu Legislative Assembly Building. The consultancy service for supply of drawings and designs to the Government of Tamil Nadu was held to be Fees for Technical Service. The contention of the applicant that the transaction is a transfer of capital asset effected offshore was not found acceptable. The Authorities commented that the mere fact that the sub-contractor was required to perform most of the services connected with the designing of the Complex, and received nearly half of the contact value did not mean that the applicant had not rendered any consultancy services apart from presenting a conceptual architectural design. The Authority also held that ratios of a few other cases including the Davy Ashmore case (supra) are not applicable in this case.

Test Your Knowledge

QUESTIONS	
1.	An Indian subsidiary of a Hong Kong based company has been making payment for 'Fees for Technical Services' by virtue of agreement dated 1st August, 1997. The Assessing Officer holds that since the agreement is between 31st May and 1st June 2005, the applicable tax rate as per section 115A is 20% of the fees payable. The deductor holds that since Hong Kong has become a part of China with effect from 1.7.1997, the DTAA between India and China should be operative. As a result, the tax should be deducted @ 10% as per the Treaty. Is the taxpayer correct?
2.	Should tax be deducted from commission payable to export agents, treating the commission as 'Fees for Technical Services'?
3.	A private Indian Management College in India has a tie up with a UK based University. By virtue of the tie up, the Engineering College would send its faculty members for getting further training in modern technological driven instructional methods. The faculty members, once trained, are expected to apply the modern methods and techniques while teaching the students. The UK University charges a consideration for the services. Determine whether the fee is taxable. Also determine if the University was located in Germany instead of the UK.

SOLUTIONS	
1.	With effect from 1.7.1997, Hong Kong has become a Special Administrative Region (SAR) of the People's Republic of China. DTAA provisions do not apply to territories which have a special status and not a part of the country. Article 3 of the Treaty definition of China does not extend to Special Administrative Regions of China. Therefore, provisions of the treaty cannot be applied. The transaction will be governed by the domestic law provisions. On the basis of the date of the agreement, the tax has to be deducted @ 20%, plus applicable surcharge and education cess.
2.	The Central Board of Direct Taxes had issued Circular No 786 dated 7th February 2000 regarding taxability of export commission and liability of deduction of tax thereon. In the Circular, it was generally held that no tax is to be deducted from such commission. The Board, by its Circular No 7 dated 20th July 2009 has withdrawn this circular. By virtue of the same circular, Circular No 23 dated 23rd July, 1969 in the matter of business connection of a non-resident has been withdrawn. The present question has assumed significance particularly because of withdrawal of Circular No 786. However, it is to be remembered that the reason the Central Board of Direct Taxes has cited for withdrawal of the above two Circulars is that they were being misused. However, withdrawal of Circular No 786 does not automatically mean that tax has to be deducted at source from commission payable to all export market agents. One has to remember that at the first place, income of the non-resident has to accrue or arise or deemed to accrue and arise in India, for tax to be deducted at source under Section 195. In all the cases where export market commission is payable, one cannot hold that income of the foreign agent has accrued or arisen or is deemed to accrue or arise in India. In some of the cases, based on facts and circumstances, the department can hold the view that the commission agent has rendered technical, management or consultancy services and the commission is actually fees for technical services. If the agent is a tax resident of a DTAA country, again a test has to be applied on the basis of the DTAA definition of FTS for that particular country. In certain other cases, based on facts and circumstances of the case, the Assessing Officer may hold that the foreign agent has business connection in India through the exporter or otherwise. In that event, portion of the income of the agent as is attributable to operations in India may be deemed to accrue or arise in India. Even in those cases, if DTAA persists, it is to be tested whether the foreign agent has a permanent establishment in India, for the corresponding income to be taxable.

	In other words, it is not correct to give a categorical reply that since the circular no. 786 has been withdrawn, tax has to be deducted from all commission payable to export agents.
3.	The payment is definitely in the nature of 'Fees for Technical Services' as per the domestic Act. Apparently, the payment also falls in the category of technical or consultancy services. In addition, the service makes available technical knowledge, experience, skill etc. to the trainee faculty members so that the fee charged by the University is taxable as Fees for Technical Service. However, if the University is UK based and it a tax resident eligible to claim the benefit of India-UK DTAA, the amount will not be taxable. This is because, the amount is payable 'for teaching in or by educational institutions' which is outside the purview of Royalties as per Indo-UK DTAA. This provision is mentioned in Article 13.5 of the Treaty. In case the University is based on Germany, the amount falls in the category of 'Fees for Technical Services'. There is no need to apply the additional 'make available' clause since this clause is not there in the India-Germany DTAA. There is no exclusion in respect of 'teaching in or by educational institutions' as in the case of the Indo-UK DTAA. The amount will be taxable.