



*cutting through complexity™*

# Taxation of Royalty, FTS & Interest

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**5 October 2013**



# Royalty / FTS Article under the DTAA

- Article 12(1) – Distribution of rights of the Contracting States
- Article 12(2) – Ceiling of Gross taxation by the State of Source
- Article 12(3) – Meaning of the term ‘Royalty’ / ‘FTS’
- Article 12(4) – Taxation of Royalty / FTS if effectively connected with PE / fixed base of non-residents in the State of Source
- Article 12(5) – Where does Royalty / FTS arise?
- Article 12(6) – Adjustments for related party transactions

# Article 12 – Backdrop

## Article 12(1)

*Royalties or fees for technical services arising in a Contracting State and **paid to a resident of the other Contracting State** may be taxed in that other State.*

- Royalty and fees for technical services taxed on **cash basis or accrual basis**?

## Article 12(2)

*However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the **beneficial owner of the royalties is a resident of the other Contracting State**, the tax so charged shall not exceed \_\_\_ per cent of the gross amount of the royalties or fees for technical services*

## Article 12(3)(a)

*The term “royalties” as used in this article **means payments of any kind** received as a consideration for the use of, or right to use any copyright of literary, artistic or scientific work including cinematograph film or films or tapes for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process or for the use of or the right to use industrial, commercial or scientific equipment, other than an aircraft, or for information concerning industrial, commercial or scientific experience;*

# Article 12 – Backdrop

## Article 12(3)(b)

*The term “fees for technical services” means payment of any kind in consideration for the rendering of any managerial, technical or consultancy services including the provision of services by technical or other personnel but does not include payments for services mentioned in Article 14 and Article 15 of this convention.*

“Make available” concept in certain DTAA's such as:

- India – USA DTAA
- India – UK DTAA etc.

## Article 12(4)

*The provisions of paragraph 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State carries on business..., **through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein**, and the royalties or fees for technical services are attributable to such permanent establishment or fixed base.*

# Article 12 – Backdrop

## Article 12(5)

*Royalties and fees for technical services shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority or a resident of that state. Where, however, the person paying the royalties or fees for technical services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base, then such royalties or fees for technical services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.*

## Article 12(6)

*Where, by special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of royalties or fees for technical services paid exceeds the amount which would have been paid in 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 the Convention.*

# Concept of Beneficial Ownership

- Beneficial ownership is a **critical condition to avail benefit** of the FTS article under the DTAA's
- There is however no specific definition in DTAA's
- Klaus Vogel defines beneficial owner as:  
Beneficial Owner is a person who is free to decide
  - Whether or not the capital / assets should be used / made available for use by others
  - How the yields from them should be used
- US Model Commentary regards beneficial owner as a person if the **income is attributable to him** for tax purposes as a resident
- OECD / US Model Commentary **excludes** receipts by **intermediaries such as agents or nominee**
- Conduit companies are classic case of non-beneficial ownership, e.g. As per the India-Swiss DTAA, the concept of beneficial owner does not apply in case of "conduit arrangements"
- Non satisfaction of this criteria could lead to denial of DTAA benefits
- 'Beneficial ownership' provision is an anti-abuse provision to prevent treaty shopping

# Beneficial Ownership – OECD discussion draft

## Background

- The term beneficial owner was introduced to clarify the meaning of the words **‘paid . . . .to a resident’**
- Currently no clarity on whether ‘beneficial owner’ should be interpreted under the domestic law or whether it has a DTAA meaning
- Treaty interpretation rules allow source countries to use domestic law to define terms not otherwise defined in a DTAA

## OECD first discussion draft dated 29 April 2011 subsequently revised on 19 October 2012

- ‘Beneficial owner’ is not to be interpreted under the domestic laws
- **To be understood in the DTAA context**
- Merely the recipient is a beneficial owner, does not mean that he is entitled to DTAA benefits with respect to such payment
- **Anti-avoidance rules may apply** for treaty entitlement
- This term should be distinguished, if it has been defined in a different context for other instruments which deal with the determination of the persons that exercise ultimate control over entities or assets

# Taxation of certain payments



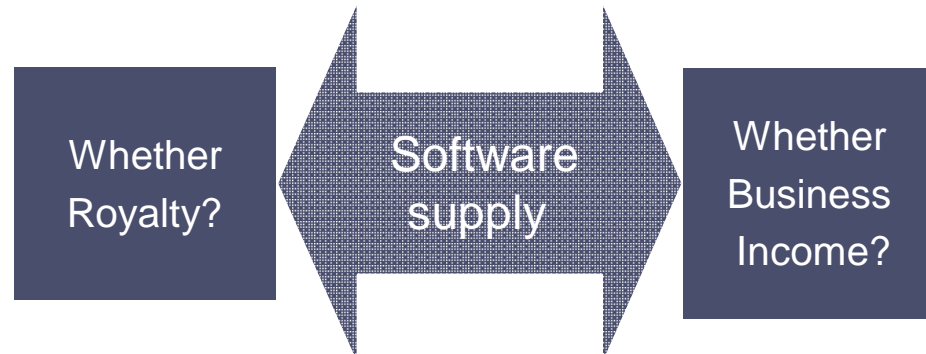


# Software Taxability – Battle with Tax Authorities

## Revenue Authorities

- Supply of software involves use / right to use of following:
  - copyright,
  - patent,
  - Invention,
  - Process, or
  - Industrial, commercial or scientific equipment
- Taxable in India as royalty on gross basis

## Characterisation of receipts from software supply

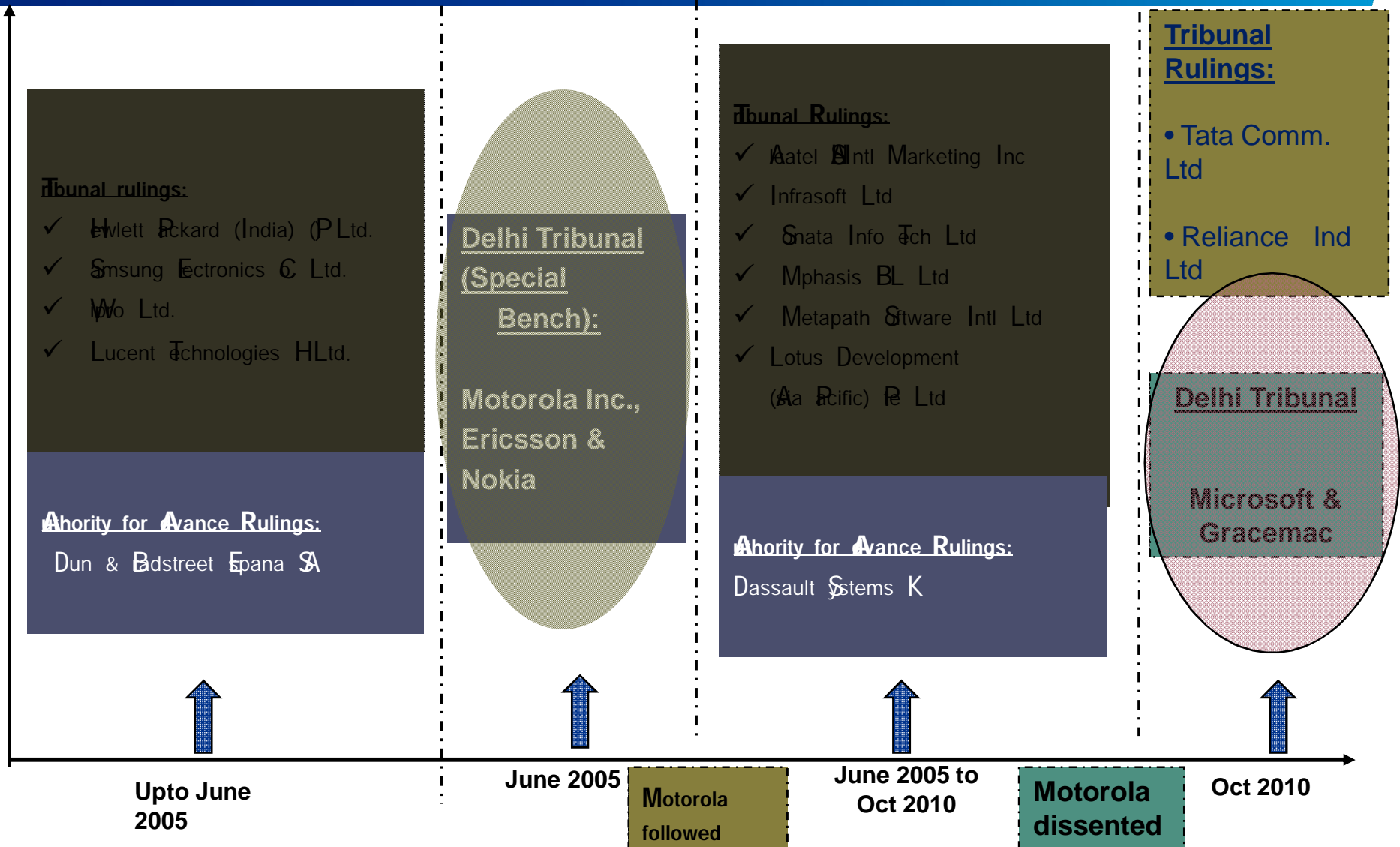


**Issue under litigation in a number of cases**

## Taxpayers

- Supply of software does not involve any use / right to use of copyright, patent, invention or process
- It is business income not taxable in India in the absence of any permanent establishment in India

# Microsoft Ruling – Disagreement with all earlier favourable rulings



# Software Taxability

## Indian Copyright Act, 1957

As per the Indian Copyright Act, copyright' means the exclusive right to do or authorize the doing of certain acts specified under section 14 of the said Indian Copyright Act.

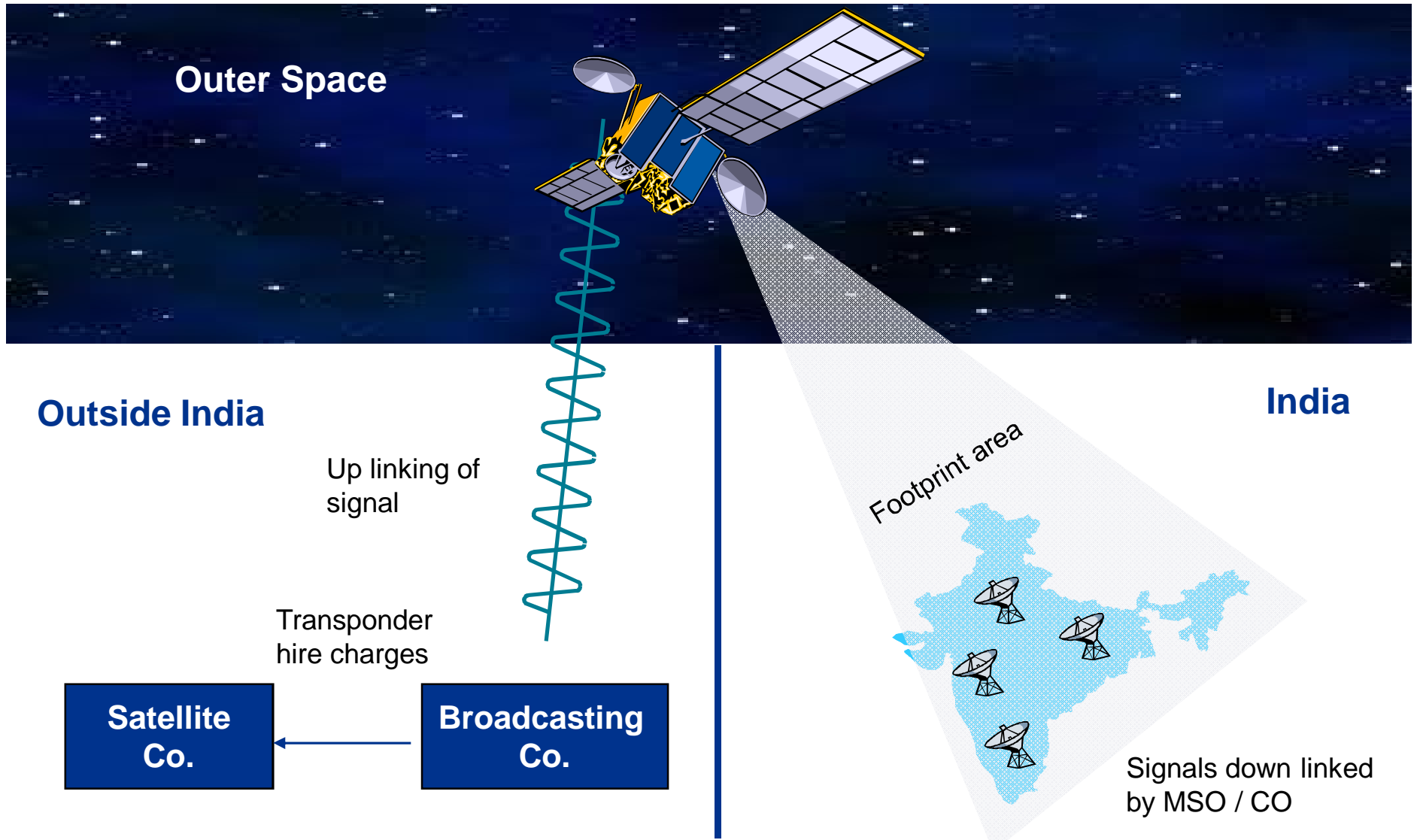
## Income-tax Act, 1961 ('the Act')

- In terms of Explanation 4 to Section 9(1)(vi) of the Act, inserted retrospectively, consideration for use of computer software under standard licensing arrangements should be regarded as 'royalty' under the Act
- The position can be continued that lump sum payments for equipment in which software is embedded should not be treated as 'royalty' so long as the embedded software is not a substantial part of the equipment
- In case where the DTAA applies, the definition of 'royalty' under the DTAA is not affected by the retrospective amendment to Section 9(1)(vi) and accordingly, payments for use of software under standard licensing agreements shall not be treated as 'royalty' under the DTAA
- However, software may be taxed even under the DTAA when the DTAA specifically provides or when the matter is referred to the Karnataka HC (who has track record of pronouncing negative precedents on software taxability)
- WHT implications u/s 195 will have to be considered

## Commentary on Article 12 of the OECD Model Convention

Commentary on Article 12 of the OECD Model Convention describes software as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software)

# Transmission charges



# Payment for Transponder Capacity – Position after amendment

## **Under the Domestic Tax law scenario**

- It is made clear by amendment by insertion of Explanation 6 in the definition of Royalty that the payment for transponder capacity is in the nature of 'Royalty' and therefore, liable for withholding under the domestic tax law
- In the case of countries with which India does not have DTAA, withholding needs to be carried out by the payer

## **Under the DTAA scenario**

- The characterization will have to be determined under the definition of royalty under the DTAA i.e. beneficial provisions of the DTAA would apply. Treaties with some countries specifically include payments for transmission by satellite, cable, optic fibre or similar technology

# Online Advertisement Charges

Whether payment for online advertisement charges constitutes Royalty, FTS or Business Income in hands of the service provider ('SP')

## Royalty

- Computer software used for delivering services of hosting
- Payment towards services and not the underlying software
- Advantage taken of equipment installed and provided by another person cannot be considered as "use of equipment" as defined in the Act
- Narrow definition in DTAA's
- Payment not to be regarded as royalty in the hands of SP

## FTS

- Applying the rule of noscitur a sociis to the definition of FTS, services cannot be treated as technical service if there is no human intervention
- There is absence of human touch in the process of advertising services
- No make-available of technical services as required under DTAA's
- Payment for online advertisement cannot be treated as FTS

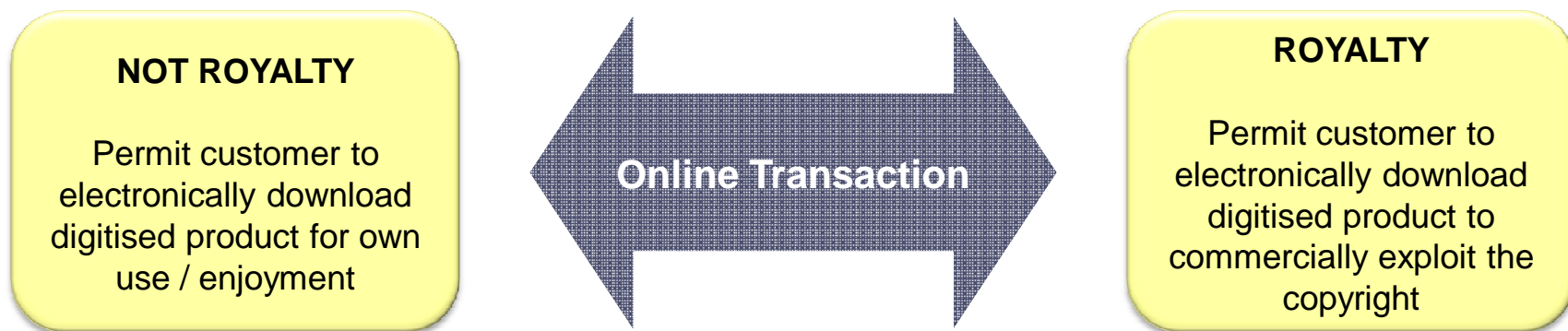
## Business Income

- Taxable only if the SP has a PE in India
- ***Is website regarded as a PE?***  
Website does not constitute a tangible property and has no location. Hence cannot constitute a PE (OECD Commentary on Model Convention)
- ***Is server regarded as a PE?***
  - Server have a fixed location hence can constitute a PE
  - If activities are not carried out through the server or are restricted to preparatory or auxiliary nature, there will be no taxability

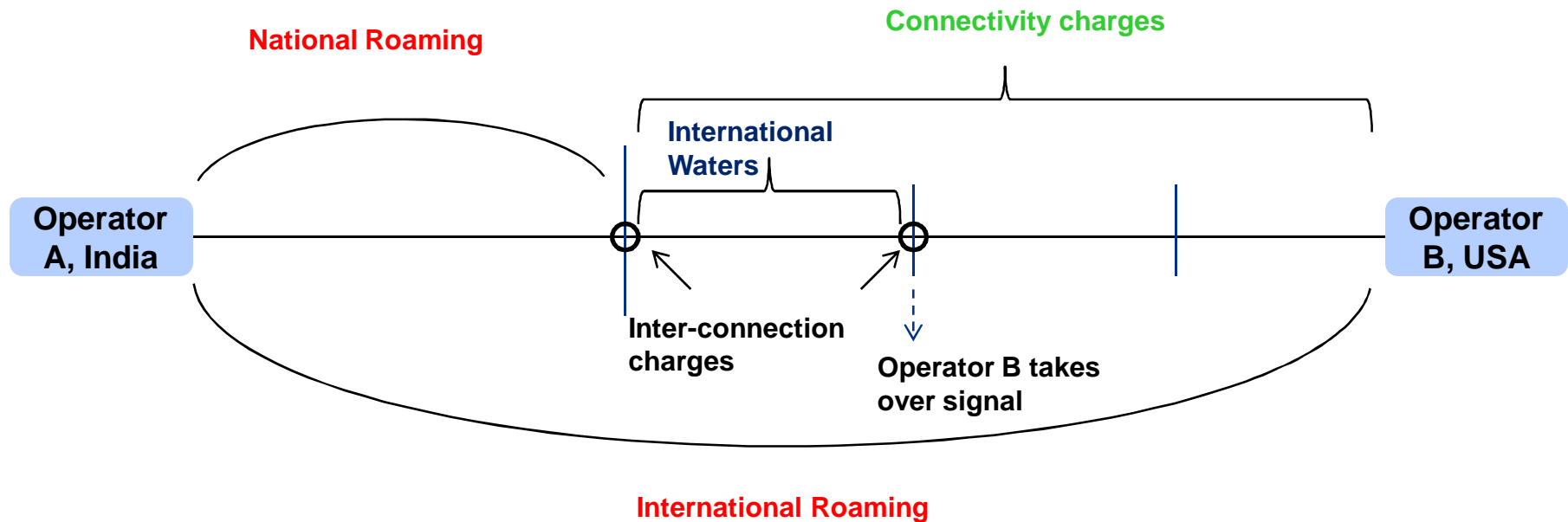
# Electronic downloading of Digitised Products

- Increase in the electronic ordering and downloading of software and digital products has created an issue whether the payments should qualify as royalty or not
- In such situations, the product is directly downloaded to the customer's hard disk or non-temporary media

## TAG Report by OECD:



# Taxation of Technology Driven Payments



International Private Leased Circuit / lease line charges act as communication medium which facilitates transmission of data from one country to another through the undersea cables capacity/optic fiber.



# Taxation of Technology Driven Payments – Some important points

## Retrospective amendment to the definition of royalty to be considered

- The terms '*process*' shall now include transmission by satellite, cable, optic fibre or other similar technology, whether or not the process is a secret
- Transmission can either mean to:
  - 'the action or process of transmitting' or 'the act of sending signals; or
  - 'signal that is transmitted'
- Accordingly, the payment for connectivity / bandwidth charges should qualify as payments '*for the use of process*' viz., transmission by satellite, cables etc. and hence, taxable as royalty under Section 9(1)(vi) of the Act

# Cloud Computing

- **Meaning :**

Cloud computing means internet based computing in which large group of remote servers are networked so as to allow sharing of data-processing tasks, centralised data storage and online access to computer services or resources

- **Cloud Services:**

1) Software as Service (SaaS) - The delivery of software applications over the internet while being managed by the service provider is known as SaaS

2) Platform as Service (PaaS) - The capability provided by Cloud service providers, for customers to use to develop and host applications is known as PaaS

3) Infrastructure as Service (IaaS) - The provisioning of computer processing time, storage, networks, firewalls and other fundamental computing resources, made available by Cloud service providers for use by customers is known as IaaS

- **Taxability:**

- Arguments can be raised that payments for certain forms of cloud computing services may be classified as FTS
- In standard structures, where client does not exercise any control over the cloud server and merely procures certain platform, infrastructure or support services, the payment to the foreign service provider shall be treated as business profits
- Business profits shall be taxable in India only if the service provider has a PE in India.

# Case Studies



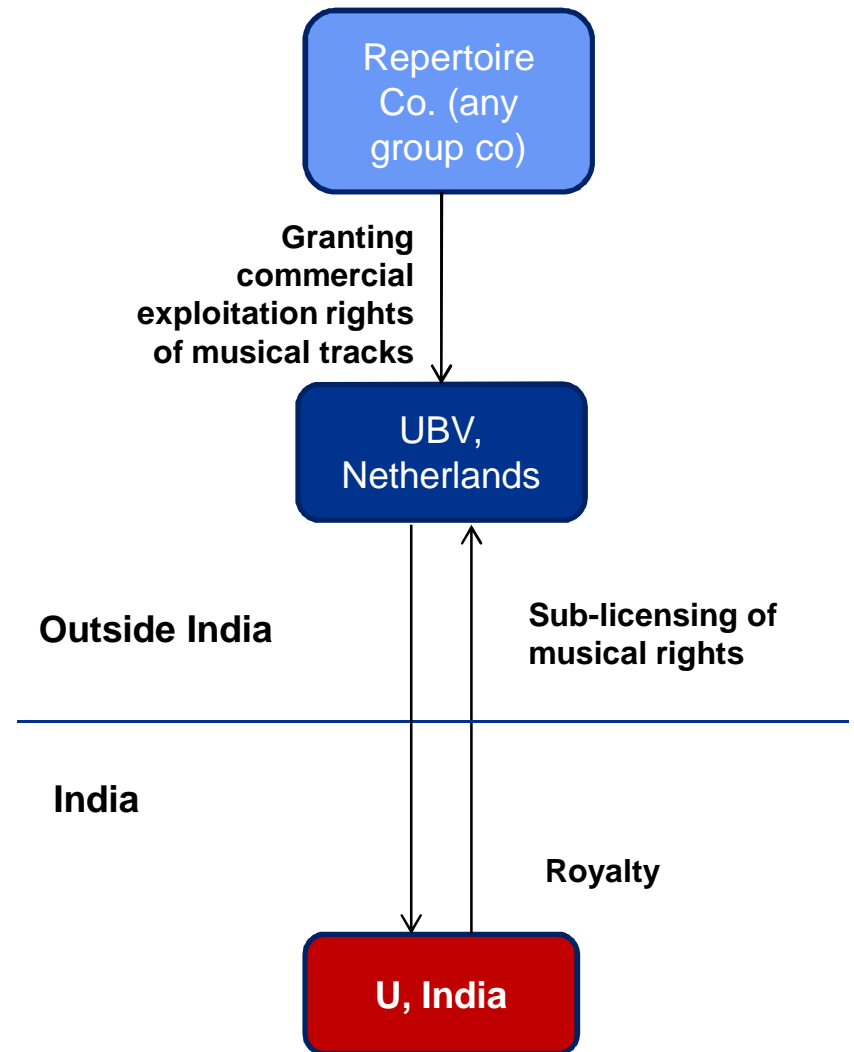
# Case Study 1

## Facts

- UBV, Netherlands is engaged in the business of developing, manufacturing and exploitation of audio and visual recordings
- It granted U, India with the commercial exploitation rights of musical tracks for India territory
- U, India paid royalty to UBV, Netherlands.
- However, the ultimate owner of these rights was the repertoire company
- TRC provided by UBV stated that UBV is a beneficial owner of the royalty income received through India

## Issues for considerations

- Who is the beneficial owner of the royalty paid – UBV, Netherlands who granted the license OR the repertoire company who is the ultimate owner of the rights?
- Whether beneficial rate of 10% under India-Netherlands DTAA for taxation of royalty be applicable in this case
- Can validity of TRC be upheld?



# Case Study 2

Outside India

**B,  
Germany**

Transfer of  
technology,  
know how  
and  
trademark

**G, India**

India

## Facts

- B, Germany entered into an agreement with G, India for transfer of technology, know how and trademark in the defined territory including India
- As per agreement, the technical information and trademark was assigned to G for exclusive use till perpetuity
- As per agreement, G was restricted from transferring the technology, know how and technical information to any other party without prior approval of B

## Issues for considerations

- Whether the payment made to B, Germany would be considered as royalty or capital gains in India?
- If an RBI approval was obtained for a limited period of 10 years, would your answer change?

# Case Study 3

## Outside India

T Ltd., UK

Fees paid

S Ltd., India

- Develop Fabric Designs
- Provide report in respect of fabric designs
- Return all the documents on termination

## India

### Facts

- As per agreement, T Ltd, UK will develop fabric designs for shirting for S Ltd.
- T Ltd. is to also supply a detailed quantity report to S Ltd. and return all the documents relating to fabric designs to S Ltd. on termination of agreement.
- S Ltd. can use these designs for his own business or sell them to any outsider for a consideration.

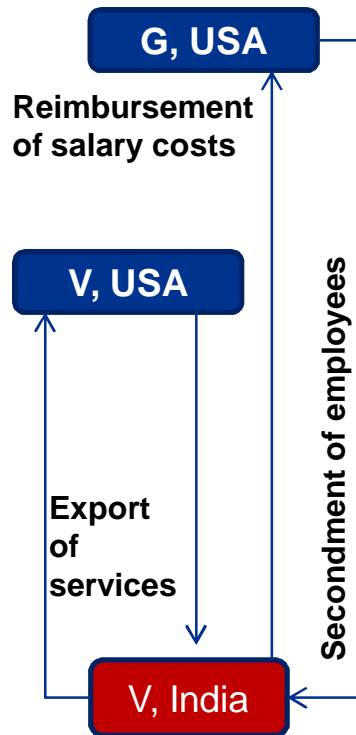
### Issues for considerations

- Whether the services rendered by T Ltd. UK are in the nature of Royalty or FTS?

# Case Study 4 (1/2)

## Facts

- Secondment of employees by V, USA through its affiliate - G, USA **to assist V India in rendering services to V, USA**
- As per “secondment agreement” which states that “to **perform managerial services**” G seconded employees, who held position like MD in V India
- G pays salary directly to employees after deducting taxes u/s 192
- V reimburses salary costs to G without deducting taxes u/s 195

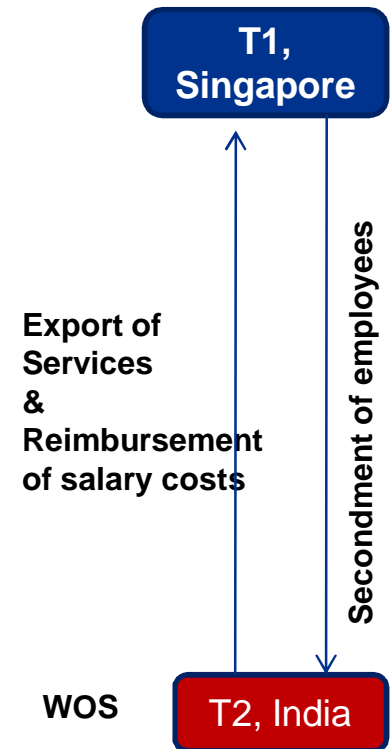


## Issues for considerations

- Salary reimbursed is income accruing to G?
- If yes, is it in the nature FTS?

## Facts

- T1 has seconded employees to T2 **to assist T2 in rendering services to T1.**
- T2 reimburses the salary and other expenses to T1 without deducting any taxes u/s 195
- However, T1 deducts tax u/s 192



## Issues for considerations

- Salary reimbursed is income accruing to T1?
- If yes, is it in the nature FTS?

## Case Study 4 (2/2)

### Features of the Secondment agreement

- Personnel perform under the supervision and control of G, USA
- G, USA has a right to terminate the services of the employees
- Employees of G, USA assumed important positions like MD
- Without G, USA seconded employees have no locus standi vis-à-vis V India

### Features of the Secondment agreement

- Personnel perform under the supervision and control of T1 India
- T1 India does not bear any responsibility or risk for results of work of the deputed employees

**Whether Structuring of Secondment Agreement could be a solution to mitigate the risk of tax exposure**



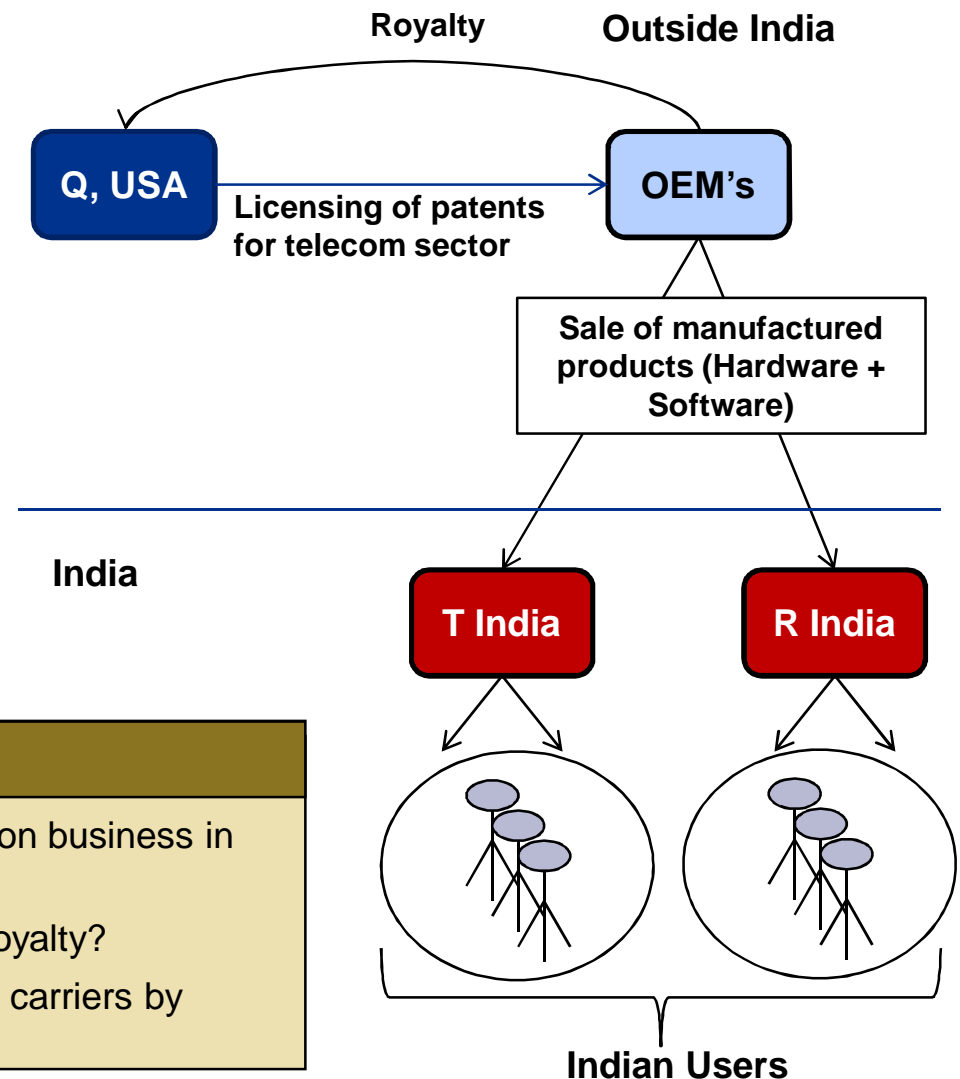
# Case Study 5

## Facts

- Q licensed its patents to CDMA technology to OEMs outside India
- License agreement was not India specific
- Using this technology, OEMs manufactured products outside India and sold them to various carriers including Indian carriers T and R
- Sales to Indian carriers was a high-sea sale
- Indian carriers then sold the products to end users in India
- For the above licenses, OEMs paid royalty to Q
- The agreement between Q and OEMs were not India specific

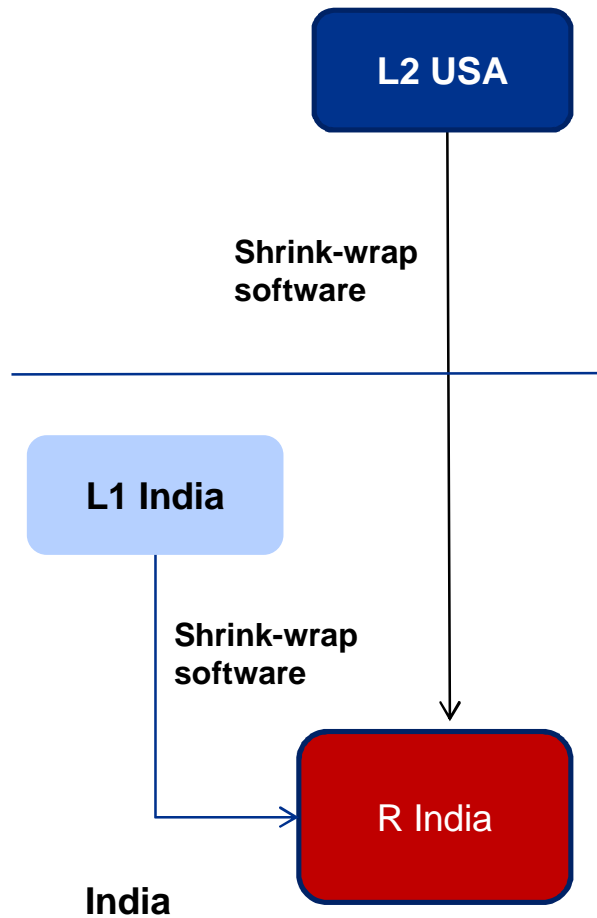
## Issues for considerations

- Whether royalty paid was for the purpose of carrying on business in India / for earning income from a source in India?
- Would the payment for patent license be taxable as royalty?
- Would software component of products sold to Indian carriers by OEMs be taxable as royalty?



# Case Study 6

## Outside India



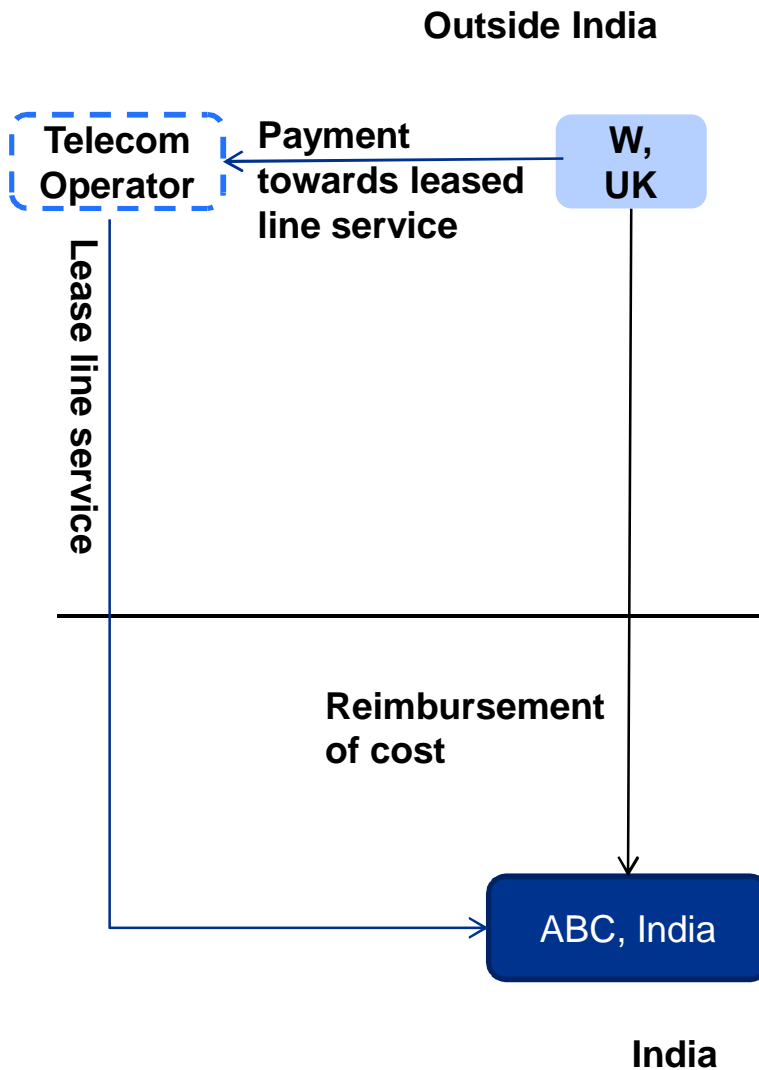
### Facts

- To establish wireless telecommunications network in India, R entered into software contract with L1 and L2
- It made payments to L2 for purchase of software without deducting any taxes

### Issues for considerations

- Whether shrink-wrapped software is a right to use copyright or copyrighted article?
- Would the above payment qualify as royalty?

# Case Study 7



## Facts

- ABC has availed the services of securing lease link from domestic and international telecom operators.
- The parent company W, UK pays the telecom operators outside India and recovers the same from M without mark-up

## Issues for considerations

- Will the reimbursement of cost to W constitute as payment for royalty in the hands of W?
- In view of the amendment to the Act, would the same be regarded as royalty in India?

# Case Study 7 – Recent Ruling

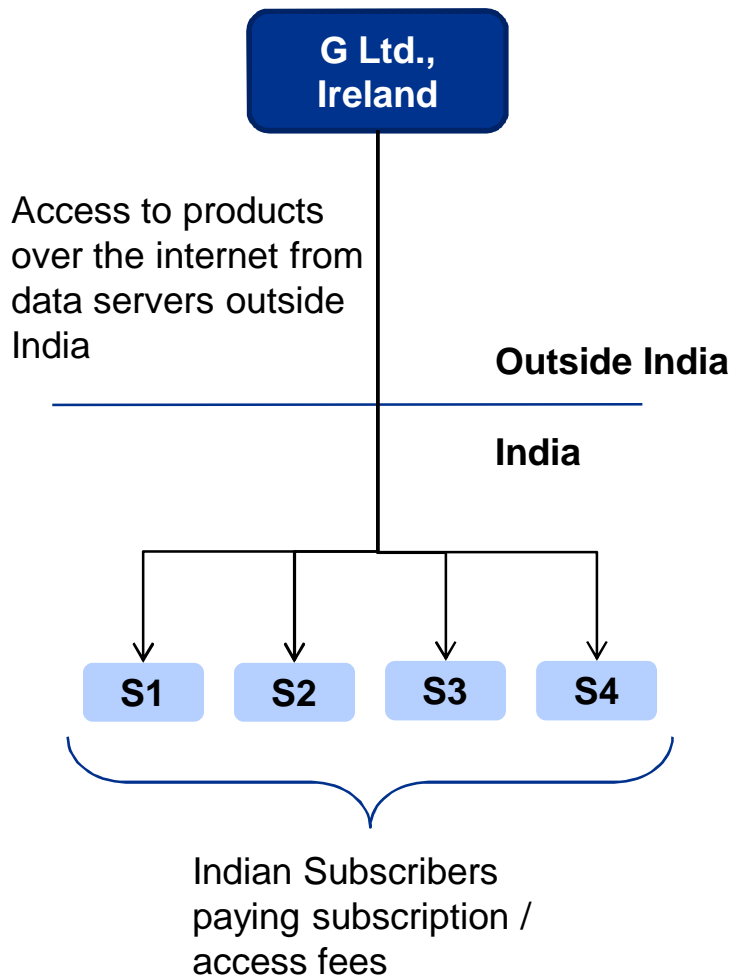
## Reimbursement of expenditure – Recent ruling

Payments to third parties, routed through related company cannot be construed as reimbursements of expenditure. In such a scenario, WHT implications u/s 195 shall apply as if such payment has been made by the taxpayer directly to the third party

- *C.U. Inspections (I) Pvt Ltd v. DCIT*

**In light of the above, should taxes be withheld on the reimbursement of cost**

# Case Study 8



## Facts

- G, Ireland is into the business of distribution of qualitative research and analysis ('products') in the form of subscriptions
- It sells these products to India customers / subscribers by providing them access over the internet from data servers located outside India
- The Indian subscribers pay subscription / access fees to G Ltd
- However, no attempt is made to impart the information to the payer
- G Ltd. does not have any permanent establishment in India

## Issues for considerations

- Whether the above payment of subscription fees is in the nature of Royalty, taxable in India?

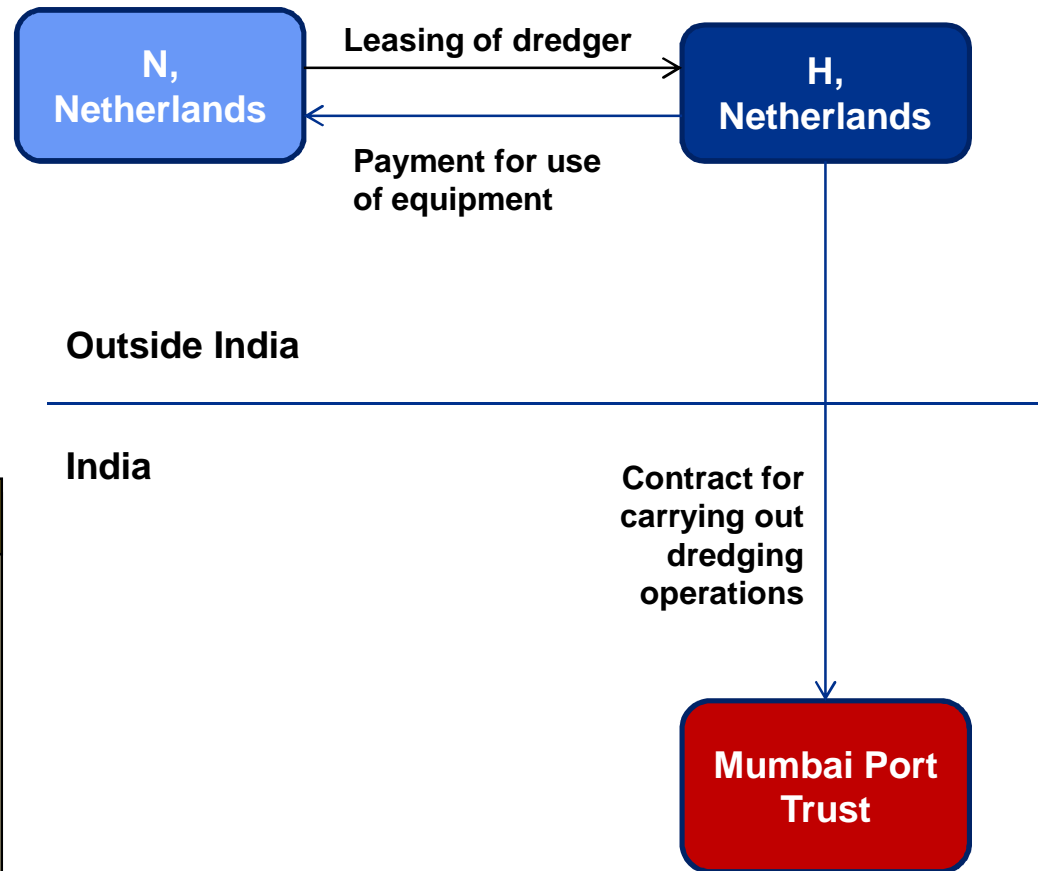
# Case Study 9

## Facts

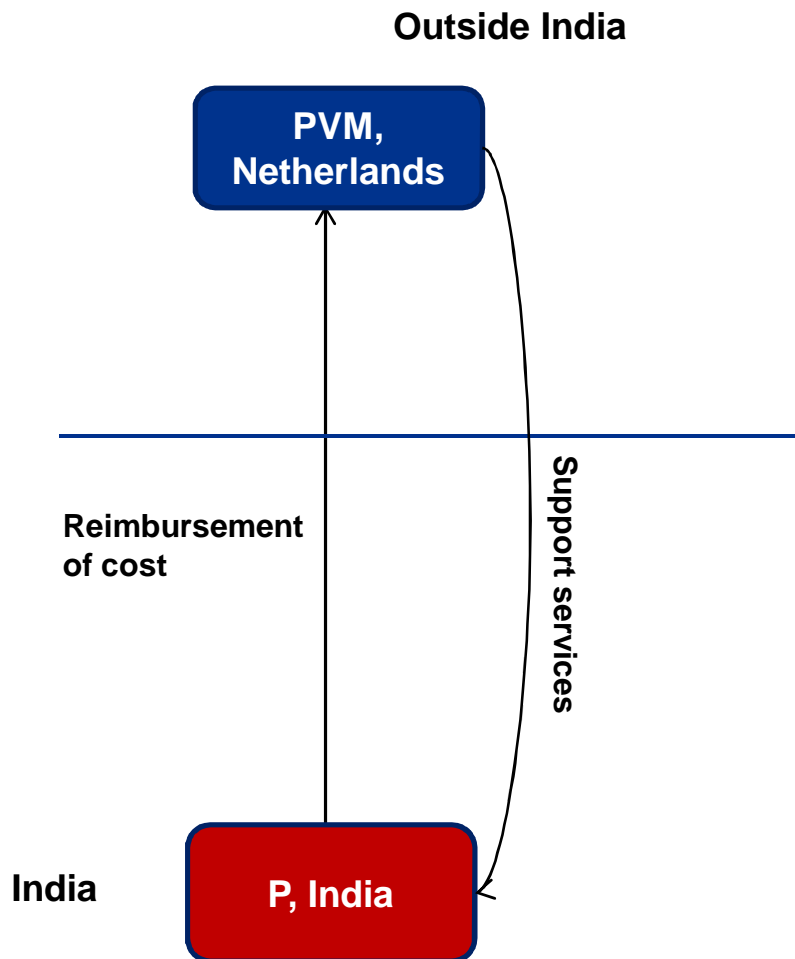
- N entered into a contract with H for lease of dredger
- The lease was a dry lease
- Dredger placed in India
- The operation, control and management of the dredger was with H

## Issues for considerations

- Whether use of equipment is taxable as royalty in India?
- Would equipment constitute PE in India?
- If the operation, control and management was with H, would the above income be taxable?
- Would your answer change if the lease is a wet lease?
- Would your answer change if the DTAA is India-USA DTAA?



# Case Study 10



## Facts

- As per the Support Services Agreement, PVM, Netherlands would provide support services to P, India
- Support services specific to confectionery industry
- Services in nature of reviewing work on Indian company and providing assistance
- The agreement for support services lists down the same services mentioned in the Trademark Technology and Know-how License Agreement ('TTLA') under which PVN receives royalty.

## Issues for considerations

- Whether the services rendered by PVN under the Support Services Agreement when read TTLA, would be taxed in India?

## Case Study 10 – Second Source Rule

### Article 12(7) of the India-USA DTAA

- (a) *Royalties and fees for technical services shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority or a resident of that state. Where, however, the person paying the royalties or fees for included services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base, then such royalties or fees for technical services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.*
- (b) *Where under sub-paragraph (a) royalties or fees for technical services do not arise in one of the Contracting States, and the royalties relate to the use of, or the right to use, the right or property, or the fees for technical services relate to services performed, in one of the Contracting States, the royalties or fees for technical services shall be deemed to arise in that Contracting State*

**In terms of the Second Source Rule, Royalty / FTS taxable in the state where Permanent Establishment exists**



**Interest**



# Interest Article under the Treaty

- Article 11(1) – Taxability of interest in Residence State
- Article 11(2) – Taxability of interest in Source State
- Article 11(3) – Meaning of the term ‘Interest’
- Article 11(4) – PE situation
- Article 11(5) – Source of interest
- Article 11(6) – Related party transactions – arm’s length principle

# Article 11 – Backdrop

## Article 11(1)

*Interest arising in a Contracting State and **paid to a resident of the other Contracting State** may be taxed in that other State.*

## Article 11(2)

*However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the **beneficial owner of the interest**, the tax so charged shall not exceed \_\_\_ per cent of the gross amount of the interest*

## Article 11(3)

*Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State shall be exempt from tax in that Contracting State provided it is derived and beneficially owned by, or derived in connection with a loan or credit extended, guaranteed or insured by:*

- (a) the Government, a political sub-division, a statutory body or a local authority of the other Contracting State; or*
- (b) (i) in the case of India, the Reserve Bank of India, the Industrial Finance Corporation of India, the Industrial Development Bank of India, the Export-Import Bank of India, the National Housing Bank, the Small Industries Development Bank of India and the Industrial Credit and Investment Corporation of India (ICICI); and (ii) in the case of Ireland, the Central Bank of Ireland; or*
- (c) any other similar institution as may be agreed from time to time between the Competent Authorities of the Contracting States.*

# Article 11 – Backdrop

## Article 11(4)

*The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits; and in particular, income from Government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article*

## Article 11(5)

*The provisions of paragraphs 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, **carries on business in the other Contracting State in which the interest arises, through a permanent establishment** situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply*

# Article 11 – Backdrop

## Article 11(6)








*Interest shall be deemed to arise in a Contracting State when the payer is that State itself or a political sub-division, local authority, or resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.*

## Article 11(7)

*Where, by special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of royalties or fees for technical services paid exceed the amount which would have been paid in 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 the Convention.*

## Article 11 – What can be considered as Interest

Whether the following can be said to be interest under the DTAA?

Particulars	Answer	Comments
Interest rate swap		Para 21.1 of OECD commentary
Interest on Convertible bond / Debenture		-
Interest on delayed income tax refund		-
Interest received by Partner of a Partnership firm		-
Premium received on Redemption of Debenture		-
Guarantee Fee		-
Commitment charges		-

## Article 11(4) – Taxation of Interest in case of a PE

Interest taxable under Article 7 (i.e. Business Profits) and not Article 11 if:

- Resident of State R carries on business in State S through a PE in State S and
- Debt claim in respect of which interest is paid is effectively connected with such PE i.e. interest paid in respect of debt claims forming part of the assets of PE

**Interest will be taxable on net basis in Country S**

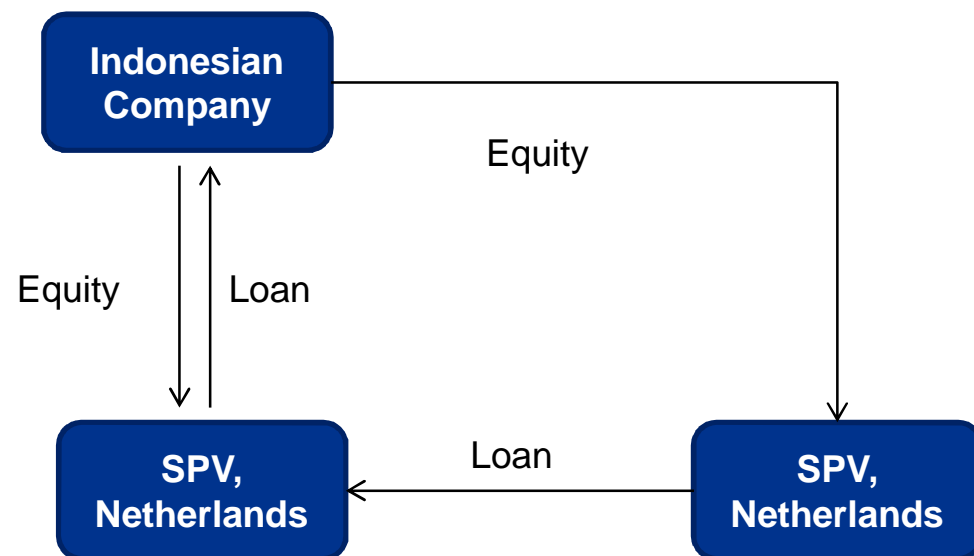
# Case Study 1

The essence of the OECD Commentary is to explain that the 'beneficial ownership' limitation is intended to exclude:

- mere nominees or agents, who are not treated as owners of the income in their country of residence;
- any other conduit who though the formal owner of the income, has very narrow powers over the income which render the conduit a mere fiduciary or administrator of the income on behalf of the beneficial owner

## Issues for considerations

- Can the SPV be considered the 'beneficial owner' of the interest?



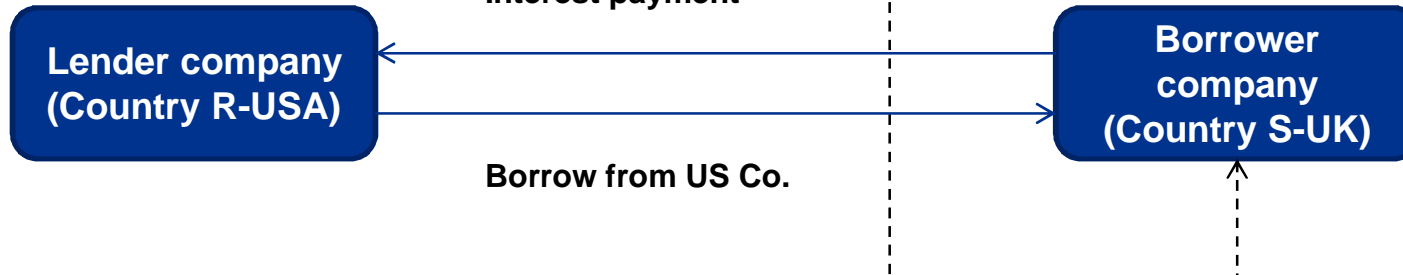


# Case Study 2

Outside India

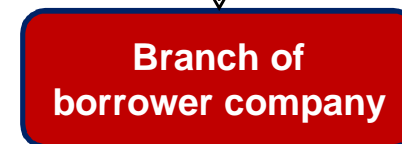
USA

UK



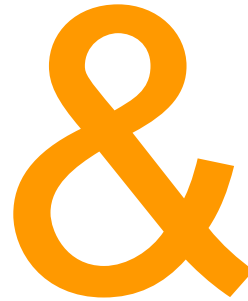
India

PE of UK  
borrower in  
India



## Issues for considerations

- Considering the fact that the indebtedness and interest incurred is borne by PE, would the interest received by the lender company be taxable in India?



Questions

Answers

# Thank You

Rishi Kapadia

