



Royalty and Fees for Technical Services CA Hiten Sutar

16 December 2017

Royalty & FTS – Overview under IT Act



Brief overview of provisions of Income Tax Act, 1961

- **Section 5 – Scope of Total Income for Non Residents**

- Income received / deemed to be received in India
- Income accruing / arising in India or deemed to accrue or arise in India

- **Section 9 – Income deemed to accrue or arise in India**

- Royalty - Section 9(1) (vi) – consideration for use of IP, equipment, etc.
- FTS - Section 9(1) (vii) – consideration for managerial, technical or consultancy services

- **Taxation of Royalty / FTS**

- Section 115A - Taxation of royalty and FTS received by NR from Government or Indian concern
- Section 44DA - Taxation of royalty and FTS received by NR from Government or Indian concern, where such royalty/ FTS is effectively connected to PE of NR in India, if any

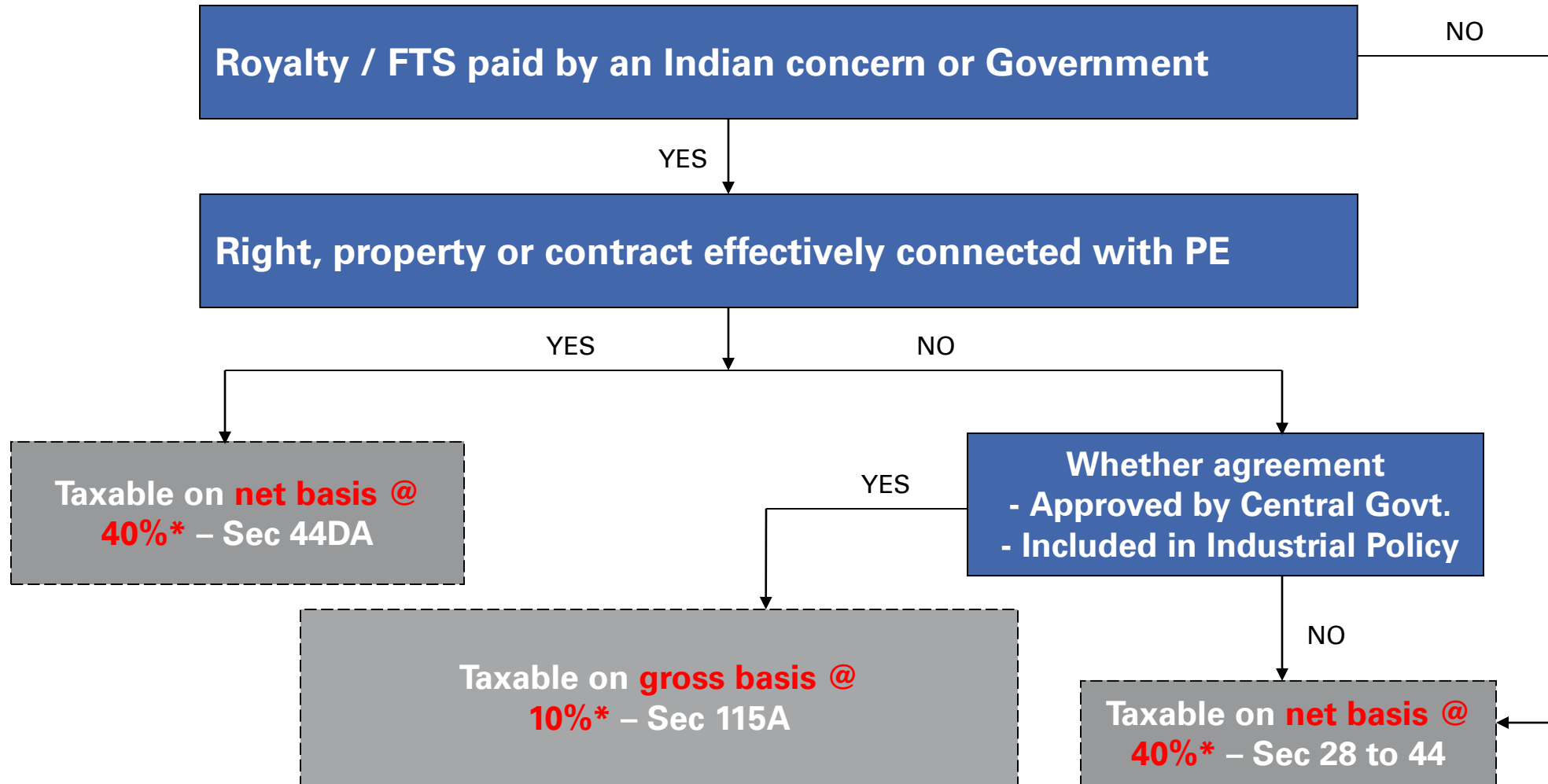
10% on gross basis

40% on net basis

○ Taxation of payment from NR to NR ?

- whether section 115A or section 44DA or any other method

Taxation of Royalty/FTS under the Income-tax Act, 1961



* Excluding Surcharge and cess, as applicable

Royalty – Definition under the Income Tax Act, 1961

- Consideration (incl. lumpsum consideration) for :

– **Transfer of all or any rights (including license) in:**

- Invention, patent, model, design, secret formula or process or trademark, etc. (IP)
- copyright, literary, artistic or scientific work including films or video tapes/tapes for use in TV/radio broadcasting

– **Imparting of any information concerning**

- the working of or use of IP
- technical, industrial, commercial or scientific knowledge, experience or skill

– **Use of**

- any IP
- or right to use any industrial, commercial or scientific equipment

- Rendering of any services in connection with above

Capital Gains, consideration for sale, distribution and exhibition of cinematographic films and amounts referred to in Section 44BB excluded

Royalty – Examples of certain terms used in definition

Transfer of intellectual property

Patent – Apple iOS is a patented software

Invention – Telephone invented by Graham Bell

Design – Wedding outfit designed by a famous designer

Secret formula or process – Formula to make a soft drink

Trademark – To use the logo of a reputed organization

Copyright – Reproduce songs of a movie

Imparting of information concerning scientific, commercial or industrial knowledge, experience or skill

- Providing the algorithm and source code relating to a software
- Making available database relating to a product prepared out of market trends, product performance, etc.

However, imparting of information available publicly shall not be royalty.

Use of industrial, scientific or commercial equipment

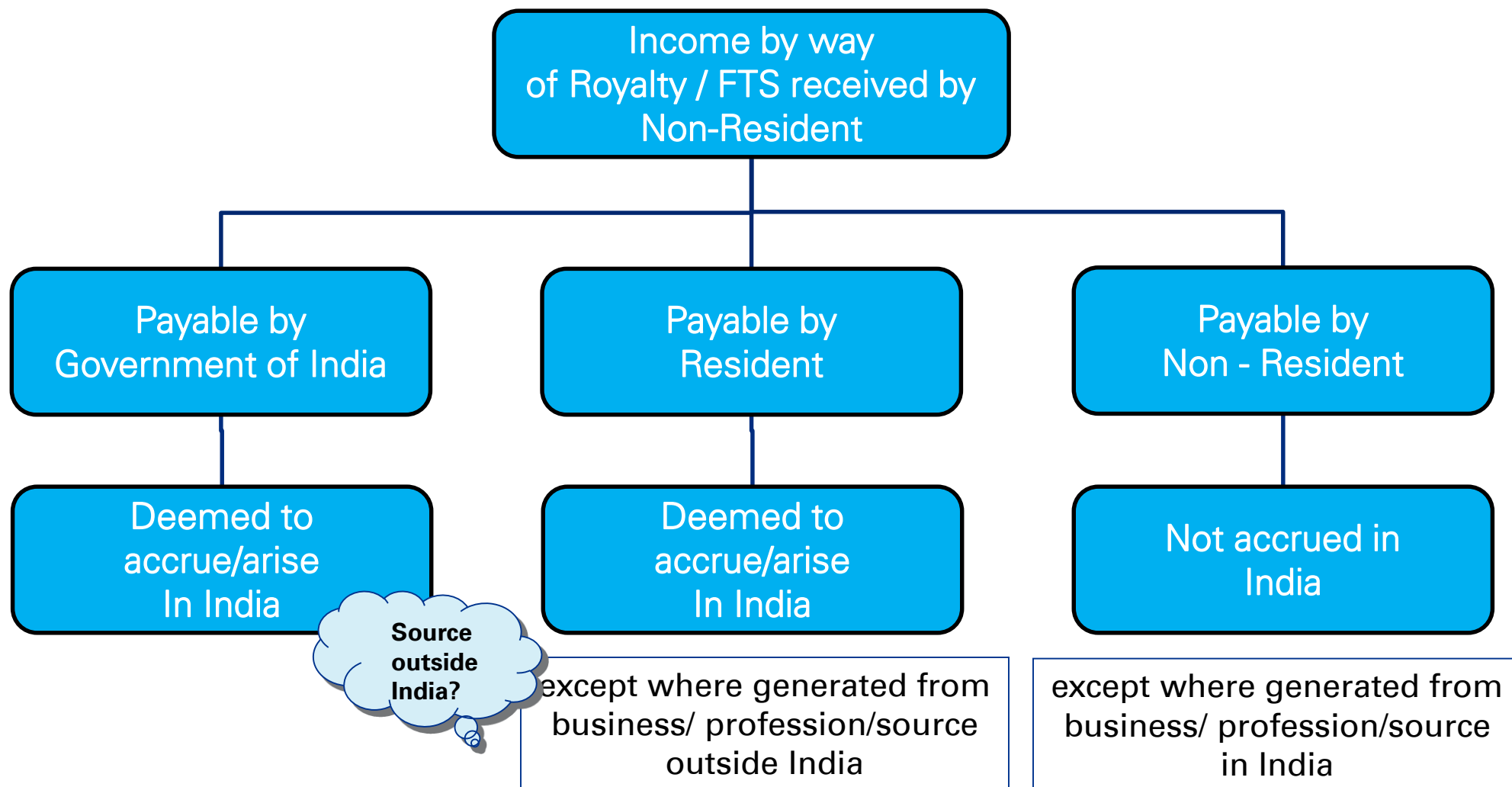
- Leasing of aircraft

Fees for Technical Services (FTS) - Definition under the Income-tax Act, 1961

- FTS - consideration for rendering
 - **Managerial, Technical or Consultancy services**
 - **Includes:**
Provision of services of technical or other personnel
 - **Excludes:**
 - Consideration for construction, assembly, mining or like project
 - Income of the recipient chargeable under the head “Salaries”



Where does Royalty / FTS arise under the Income-tax Act, 1961



Royalty & FTS

Certain issues and case laws



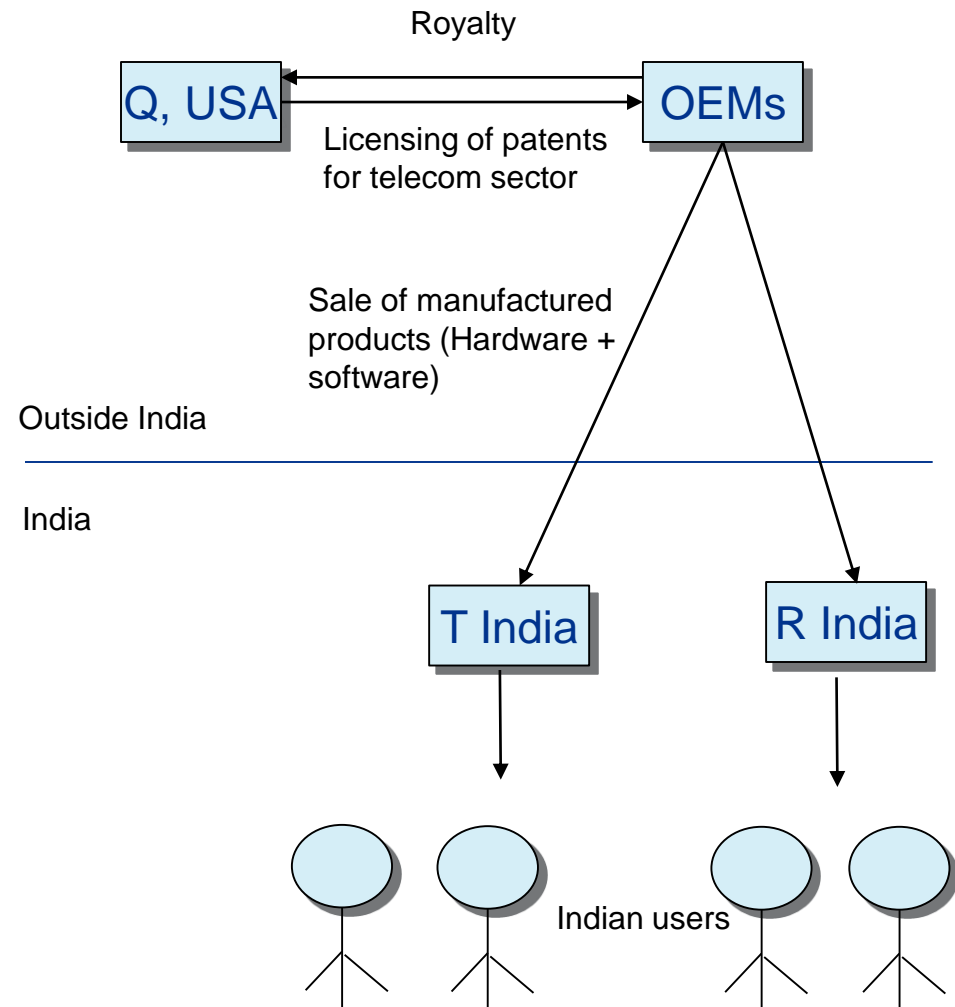
Use of license outside India

Facts

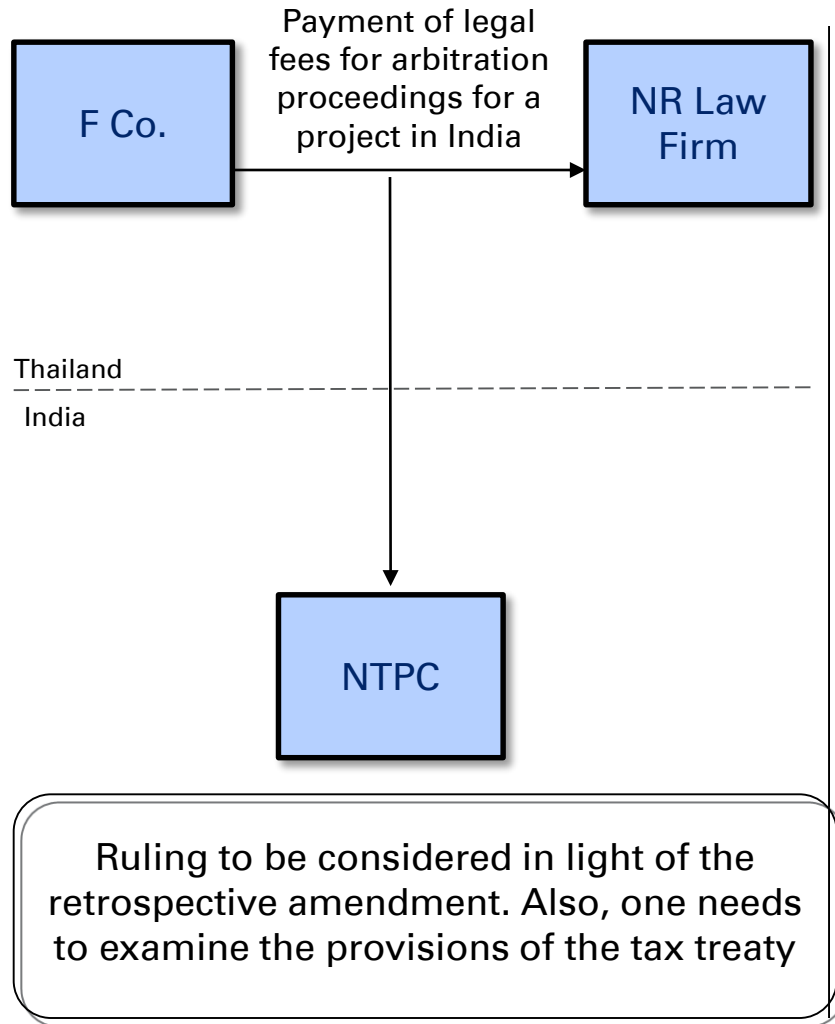
- Q licensed its patents to CDMA technology to OEMs outside India
- License agreement was not India specific
- Using this technology, OEMs manufactured products outside India and sold them to various carriers including Indian carriers T and R
- Sales to Indian carriers was a high-sea sale
- Indian carriers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

Issues for consideration

- Whether royalty paid was for the purpose of carrying on business in India / for earning income from a source in India?



Rendering Services outside India



Facts of the case

- F Co. is a tax resident of Thailand engaged in execution of hydroelectric-power project of NTPC.
- F Co. made payment of legal expenses to a law firm in Thailand (NR Law Firm) in relation to arbitration proceedings conducted in Thailand in relation to the hydroelectric-power project of NTPC.

Issue under consideration

Whether the payment made by F Co. to NR Law Firm in Thailand was chargeable to tax in India?

Held

- The legal expenses have been paid in Thailand by F Co. to NR Law Firm.
- The following details are observed about NR Law Firm:
 - i. It is a resident of Thailand;
 - ii. It does not have any office or agent or branch in India;
 - iii. None of the partners or employees are present in India during any of the arbitration proceedings;
 - iv. Entire arbitration proceeds were held in Thailand in terms of the agreement between the parties;
 - v. Payment to the law firm was made by head office in Thailand;
 - vi. Services were performed in Thailand.
- Therefore, it was held that when services were not rendered in India, the amount shall not be taxable as fees for technical services.

Export Commission

Export commission paid for procuring orders abroad – whether FTS ?

- a) Whether the same falls within the meaning of managerial or technical or consultancy services?
- b) Implication of withdrawal of Circular no. 23 of year 1969 and Circular 786 of year 2000

Case study

Orient Express (Madras HC) – [2015] 56 taxmann.com 331 (Madras) – following Faizan Shoes P Ltd (Madras HC) – 226 Taxman 115 –also referred to Toshoku – 125 ITR 225 (SC)

Held: Services rendered by NR selling agents can best be called as a service for completion of the export commitment and should not fall within the meaning of FTS. No operations of the Agent's business carried out in India

Should services have human interface?

Kotak Securities Ltd (2016) 383 ITR 1 (SC)

- Payments are not in the nature of FTS as Modern day scientific and technological developments tend to blur the specific human element in an otherwise fully automated process.

Bharti Cellular Ltd (2011) [330 ITR 239](SC)

- Payments in the nature of inter-connect charges by one telecom company to another telecom company may not be regarded as payment in the nature of FTS unless it involves human intervention. The SC held that payments are not in the nature of FTS as:– Modern day scientific and technological developments tend to blur the specific human element in an otherwise fully automated process

ITO v. Right Florists Pvt. Ltd (2013) [25 ITR(T) 639] (Kolkata Tribunal)

- No human touch involved in the whole process of online advertisement on search engine of Google and Yahoo. As long as there is no human intervention in a technical service, it cannot be taxed as “FTS”

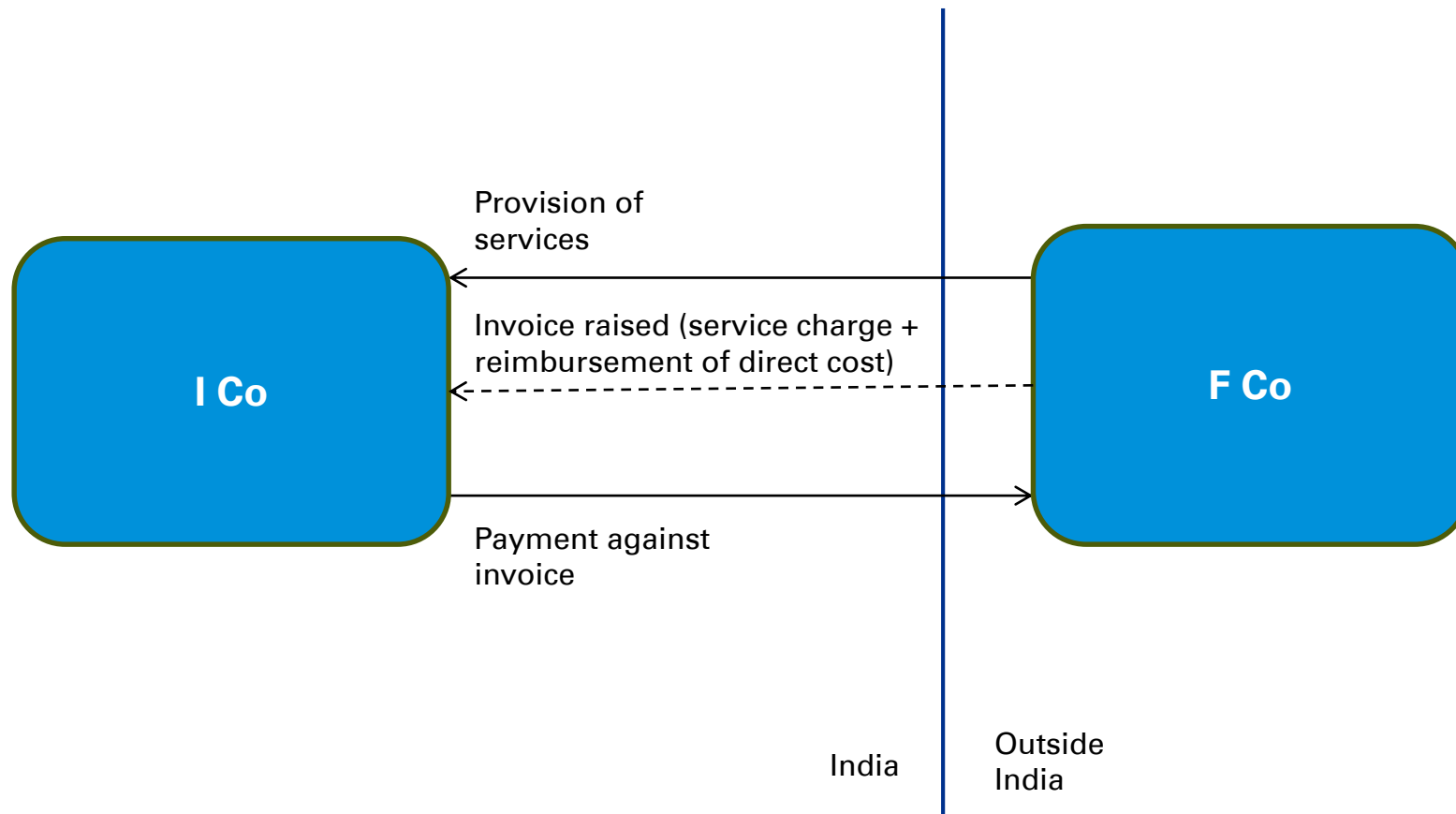
ITO v Primenet Global Ltd (2016) [48 ITR (T) 451] (Delhi Tribunal)

- Absence of human intervention for providing bandwidth, the payments made for utilizing services was not in the nature of technical services governed by section 194J”.

Siemens Ltd v CIT (2013) [23 ITR(T) 86] (Mumbai Tribunal)

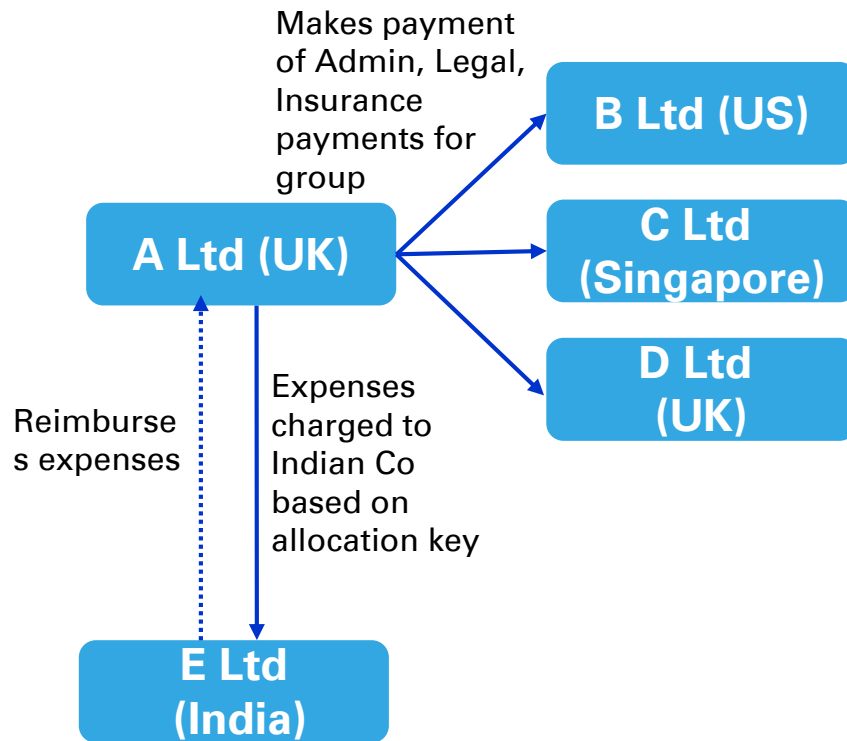
- Technology or Machine developed by human and put to operation automatically, without any human interface or intervention, usage of such technology cannot per se be held as rendering of "technical services" by human skills.
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Reimbursement



Issue : Where F Co provides service to an Indian resident company, whether while remitting the sum (including reimbursement of expenses) any tax is required to be withheld under Section 195 in India?

Reimbursement – cost reimbursement / allocation



Types of Reimbursements

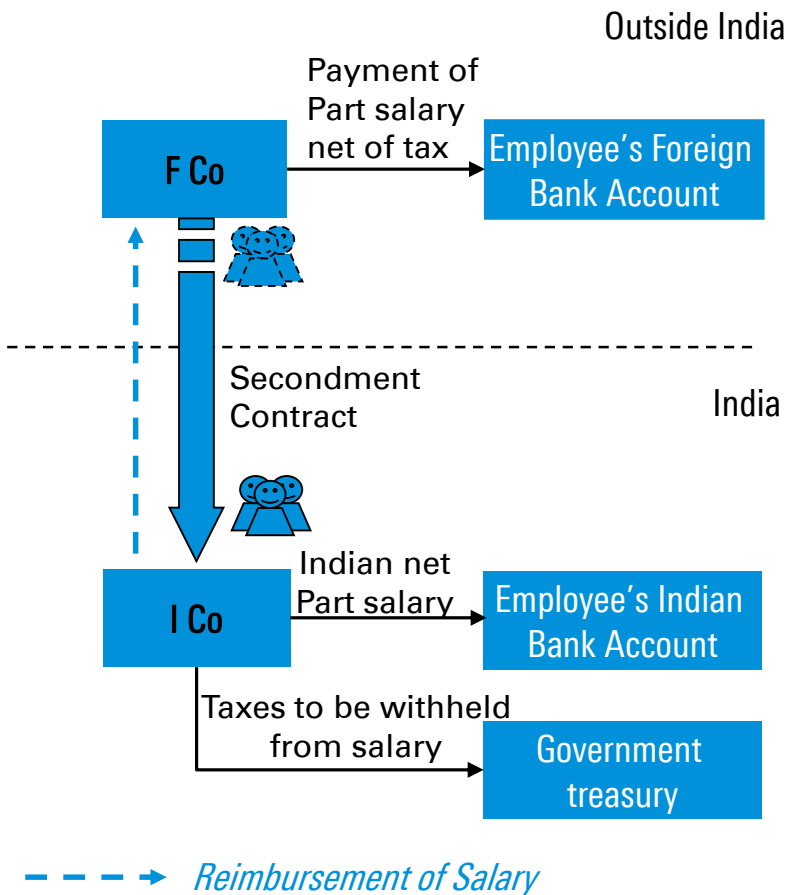
- Third party vendors involved - For administrative convenience, one company on behalf of group company enters into contract with vendor, make payment and subsequently recover
- Third party vendors not involved - Group company recovers cost it has incurred. For example: An employees works for multiple group companies and salary paid by Company X. Company X allocates the salary cost amongst various group companies on the basis of time spent

Mechanics

- A Ltd makes payment of administrative, legal, insurance and other cost to third parties B Ltd, C Ltd and D Ltd for the benefit of the group;
- A Ltd then allocates the said cost to its wholly owned subsidiary E Ltd based on an allocation key;
- E Ltd reimburses the cost to A Ltd

Issue - Whether TDS will be deducted on the salary and overhead cost reimbursed as FTS?

Secondment arrangement



Mechanics

- F Co secondments employees to I Co under dual employment (Employees remain in employment with F Co and on secondment, enter into an employment contract with I Co also)
- Employees to report and work under the management / control / supervision / instructions of I Co
- Whole or part remuneration is paid by F Co and later on recovered from I Co
- I Co would pay F Co against recharge of salary cost net of the taxes
- I Co pays part of the salary after withholding taxes on the total salary to the employee's Indian bank account
- I Co deposits taxes withheld by it to the Government treasury

Issue

- Whether TDS will be deducted on salary reimbursed by I Co to overseas entity as FTS?

Issues in Gross basis method of Taxation

Whether Royalty / FTS be taxable under net basis at the option of the NR?

Whether NR can adopt cash basis of taxation?

Whether NR can claim deduction for write off in subsequent years?

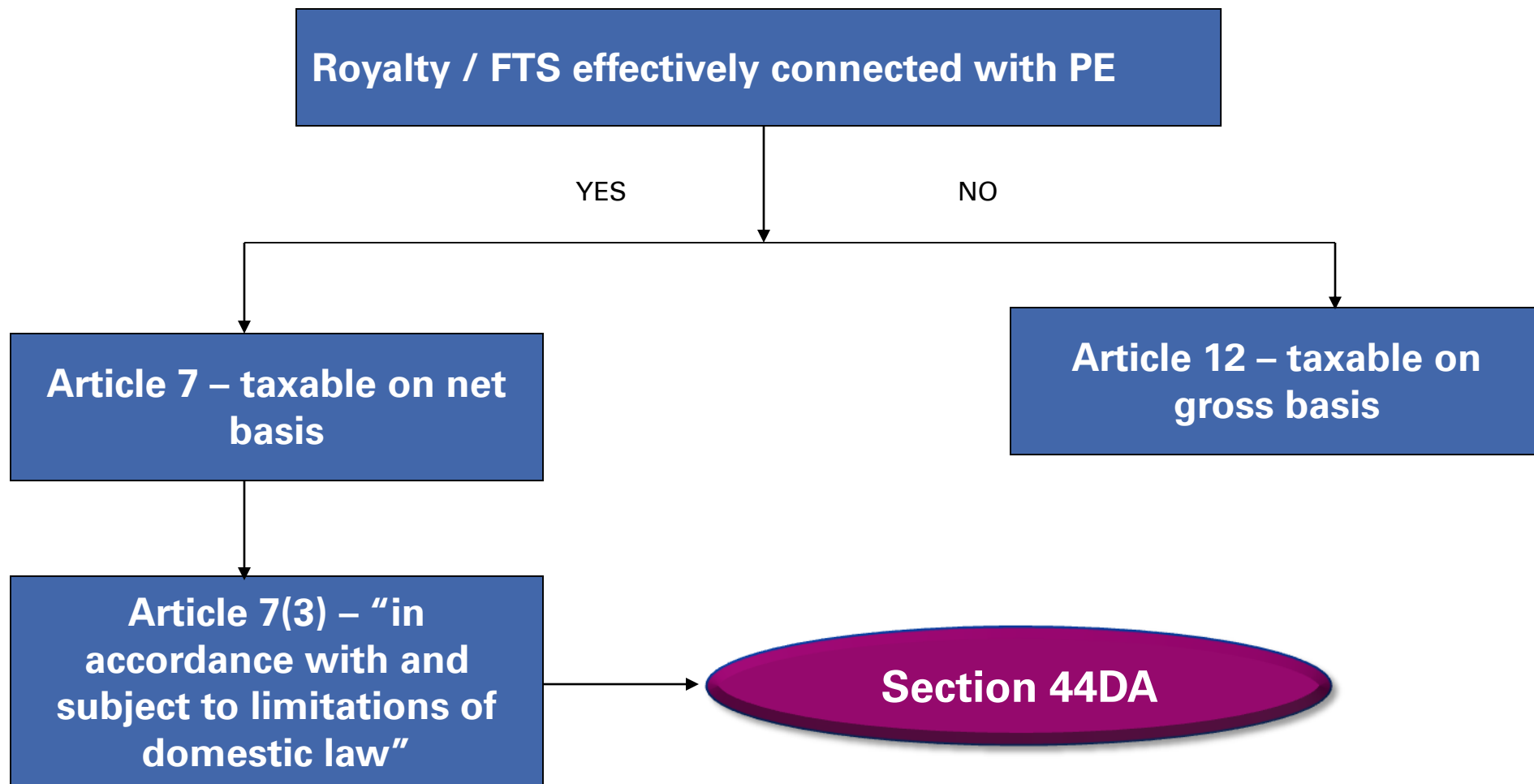
Whether Tax Audit Report required to be obtained?

Rate of conversion of income in foreign currency

Royalty – As per treaty



Taxation of Royalty/FTS under the Treaty



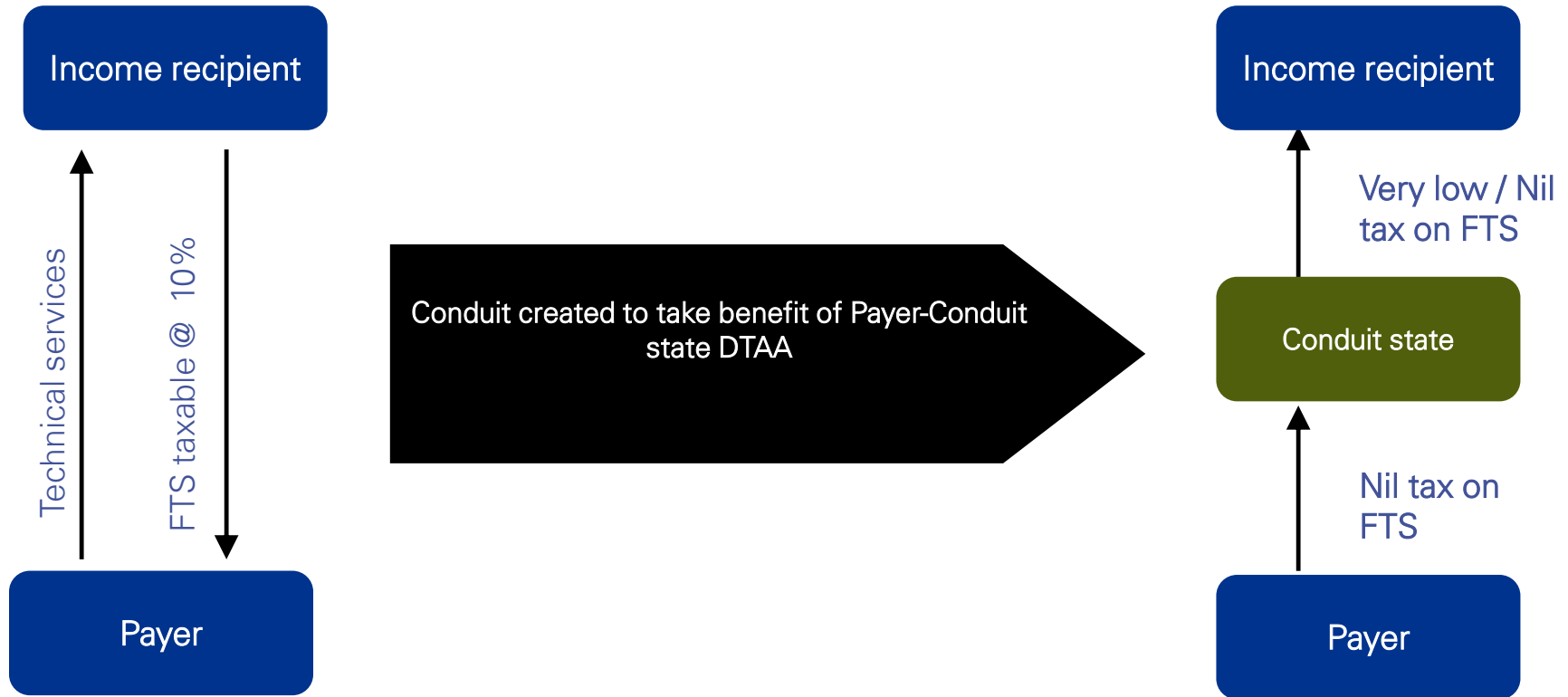
Royalty/FTS Article under the Treaty

- 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 (1) and 12 (2)

- Article 12(1) - *“Royalties arising in a Contracting State and **paid to a resident of the other Contracting State** may be taxed in that other State.*
- Article 12(2)
*“ However, such royalties 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.*

Concept of Beneficial Ownership: Use of Direct Conduit



Benefit of Payer-Conduit DTAA is availed by a person not entitled to it

* Source- OECD report on Double tax conventions & the Use of conduit Companies

Article 12 (4) – Royalty effectively connected with the PE

- Article 12(4) -*The provisions of paragraphs (1) and (2) shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, (a) carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein or (b) performs in that other State independent personal services from a fixed base situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base.*

In such case, provisions of Article 7 or Article 14, as the case may be, shall apply.

Article 12 (5) - Where does the Royalty arise – as per Treaty

- *Royalties shall be deemed to arise in a Contracting State when the payer is a **resident of that State**.*
- *Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not,*
 - (a) has in a Contracting State a **permanent establishment or a fixed base** in connection with which the liability to pay the royalties was incurred, and*
 - (b) such royalties are **borne by such permanent establishment or fixed base,****then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.*

Whether payment from non-resident (not having a PE) to another non-resident can constitute royalty under treaty?

Article 12 (6) – Adjustments for related party transactions

- *Where, owing to a special relationship between the payer and the person beneficially entitled to the royalties....., the amount of the royalties paid or credited, exceeds the amount which might have been expected to have been agreed upon by the payer and the person so entitled in the absence of such relationship (referred to as APL), the provisions of this Article shall apply only to ALP.*
- *In that case, the excess part of the amount of the royalties paid or credited shall remain taxable according to the law, of each Contracting State...*

Royalty – Definition under the Treaties

- **OECD Model** - Payments of any kind received as a consideration for:

- **Use of or right to use:**

- Patent, trademark design or model, plan, secret formula or process,
- Copyright of literary, artistic or scientific work including cinematograph films

- **Information concerning**

- industrial, commercial or scientific experience

- **UN Model** - Payments of any kind received as a consideration for:

- **Use of or right to use:**

- Copyright of literary, artistic or scientific work including cinematograph films **or films or tapes used for radio or television broadcasting**
- Patent, trademark design or model, plan, secret formula or process
- **industrial, commercial or scientific equipment**

- **Information concerning**

- industrial, commercial or scientific experience

Implications - expansion of Royalty definition

- **In case of non-treaty entity** – Retrospective expanded definition applies
- **Article 3(2)** - Any term not defined in the Treaty shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Treaty applies
- **Section 90(3) r.w. Explanation 3:** If a term is not defined in the Treaty, it may be defined by the notification issued by the Central Government and it shall have effect from the date on which the Treaty came into force.
- **Cases post amendment by Finance Act 2012 (treaty benefits still available)**
 - Nokia Networks OY (Del HC) (25 taxmann.com 225)
 - WNS North America Inc. (Mum ITAT) (2012-ITA No 8621/Mum/2010)
 - B4U International Holdings (Mum ITAT) (21 taxmann.com 529)

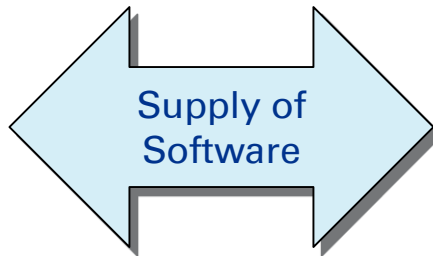
Software Taxability

Income Tax Authorities

- Supply of software involves use / right to use of following:
 - Copyright;
 - Patent;
 - Invention;
 - Process; or
 - Scientific work
- Taxable in India as royalty on gross basis

Characterization of receipts from software supply by foreign companies / entities / persons

Whether royalty?



Whether Business Income?

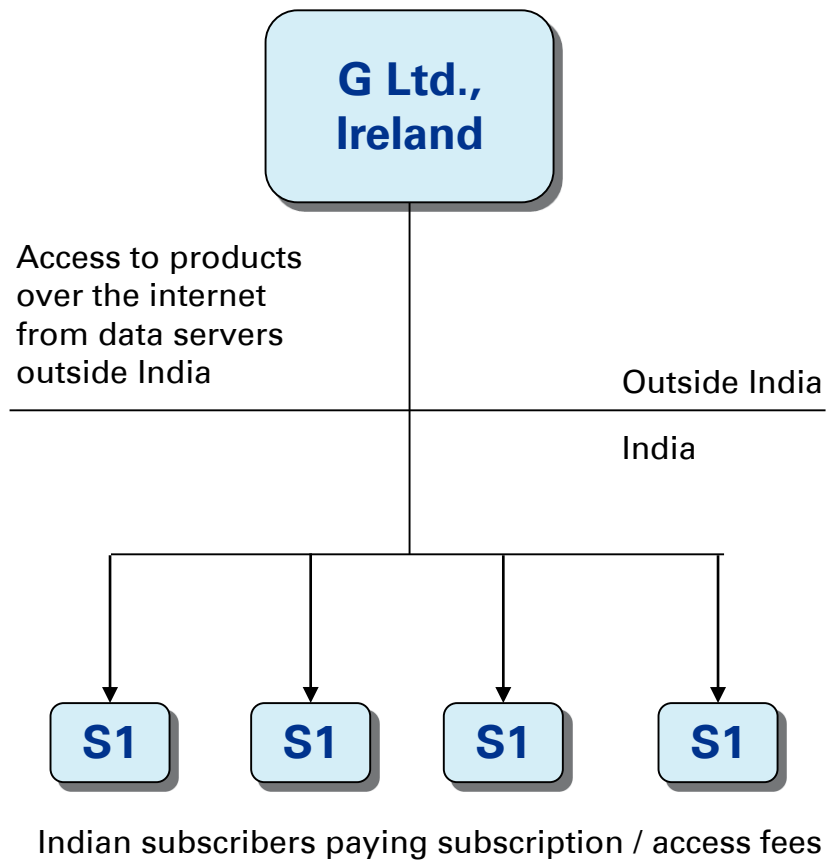
Issue under litigation in a number of cases pre and post introduction of Explanation 4 to Section 9(1)(vi)

Taxpayers

- Supply of software does not involve any use / right to use of copyright, patent, invention or process
- It is for use of a copyrighted product / article and thus, business income, not taxable in India in the absence of PE in India
- Reliance placed on OECD and international commentaries

Question currently pending before the Supreme Court primarily from series of negative decisions of Karnataka HC

Subscription



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 Consideration

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

FTS – As per treaty

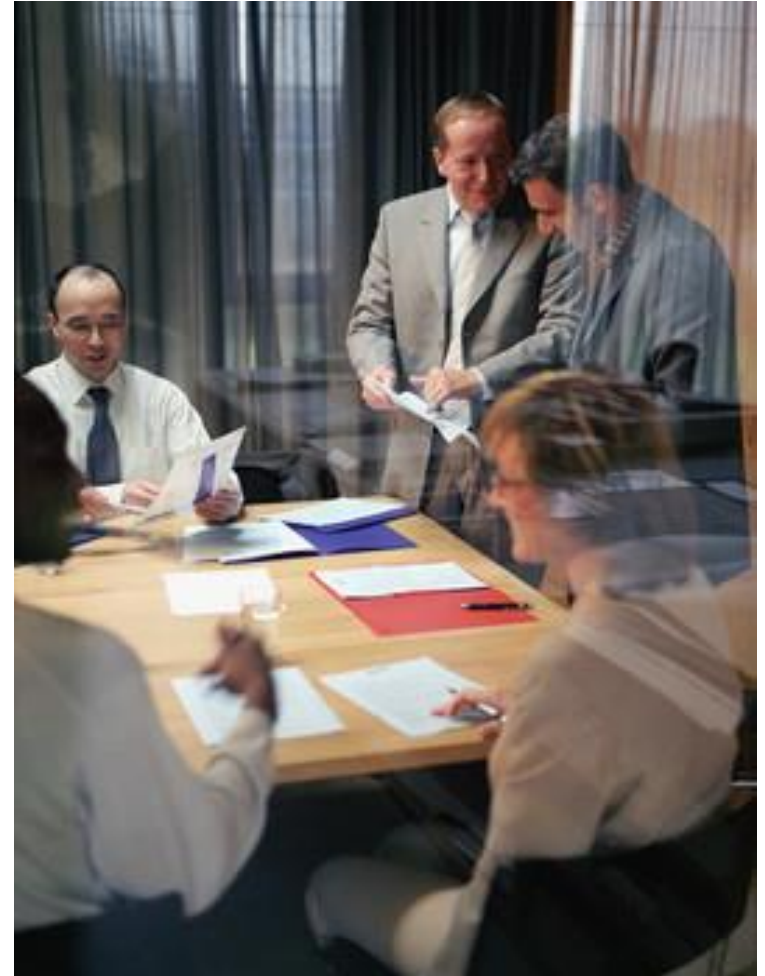


FTS under the DTAA

- **OECD/UN/US Model Conventions do not contain a specific Article for FTS**
 - Therefore, taxability of FTS to be considered either under Article 7 (Business profits), or Article 14 (Independent Personal Services) or Article 21 (Other income)
- However, most of the **Indian DTAA**s have a specific provision for taxing FTS (in certain DTAA's **along with Royalties**)
- Most DTAA's have FTS embedded with 'Royalty' whereas a few DTAA's like **Malaysia, Vietnam, etc. have a separate FTS Article**
- A few DTAA's have a different name to FTS Article for e.g. **'Technical Fees' (Oman), 'Management Fees' (Tanzania)**

FTS under the DTAA

- Some of the DTAAAs have 'Fees for Included Services' (**FIS**) **article** for e.g. Canada, USA, Portugal, etc. Some also provide '**make available**' **concept** for e.g. USA, UK, Australia, Singapore, etc.
- DTAA with **Australia and Brazil** cover FTS/FIS **within the term 'Royalties'**
- Some of the **Indian DTAAAs do not have the FTS/FIS Article** for e.g. UAE, Philippines, Thailand, Syria, etc.



FTS – definition under the treaties

–Most of the Indian DTAAAs define FTS as follows:

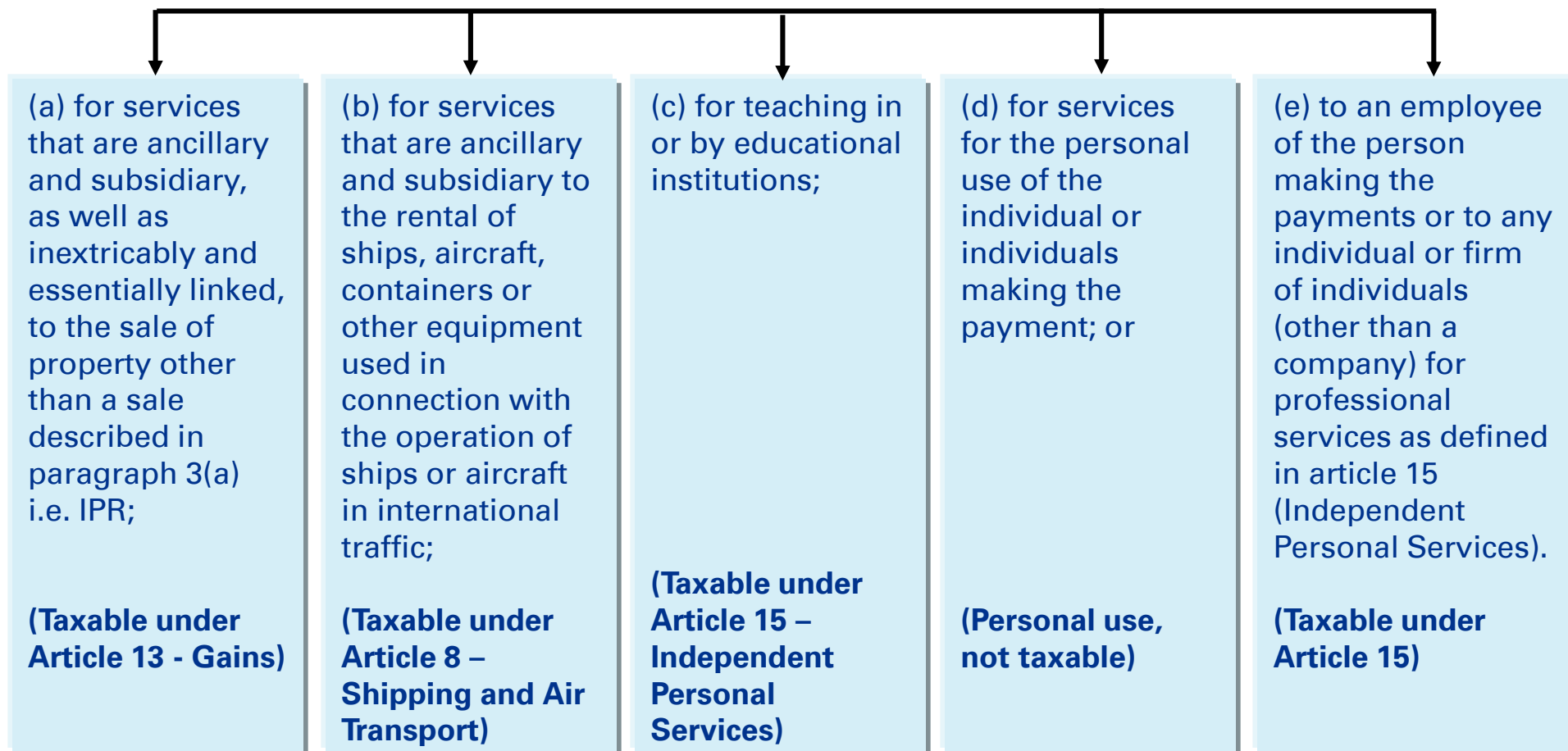
Payment is FTS if -

- Payments of any kind
 - to any person, other than payments to an employees of the payer [and for Independent Personal Service (IPS)#]
 - in consideration for certain services; and
 - such services are:
 - of **managerial, technical or consultancy** nature or
 - provision of services of technical or other personnel
- # Some of the DTAAAs do not provide specific exclusion for IPS for e.g. China, Germany, Austria, South Africa, Turkey, Brazil, etc.



FTS under the DTAA

"Fees for technical services" does not include amounts paid:



Meaning of “make available”

- The text in the treaty

(b) make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design
- **Treaties with US, UK, Singapore, Australia, Canada, etc. have the concept of “make available” in the FTS definition**
- **Judicial precedents / support**
 - MOU to India - US DTAA
 - Raymonds Ltd - 86 ITD 791 (Bom)
 - Intertek Testing Services - 307 ITR 418 (AAR)
 - CESC - 87 ITD 653 (Cal)
 - De Beers India – 346 ITR 467 (Kar HC)

**“Make available” significantly narrows down
the scope of FTS**

Meaning of “make available”

Memorandum of Understanding to India-US Treaty

- Person acquiring the service is enabled to apply the technology
- Mere requirement of technical input by a person providing services does not necessarily mean that technical knowledge is “made available”
- Use of a product which embodies technology cannot be considered to make technology available

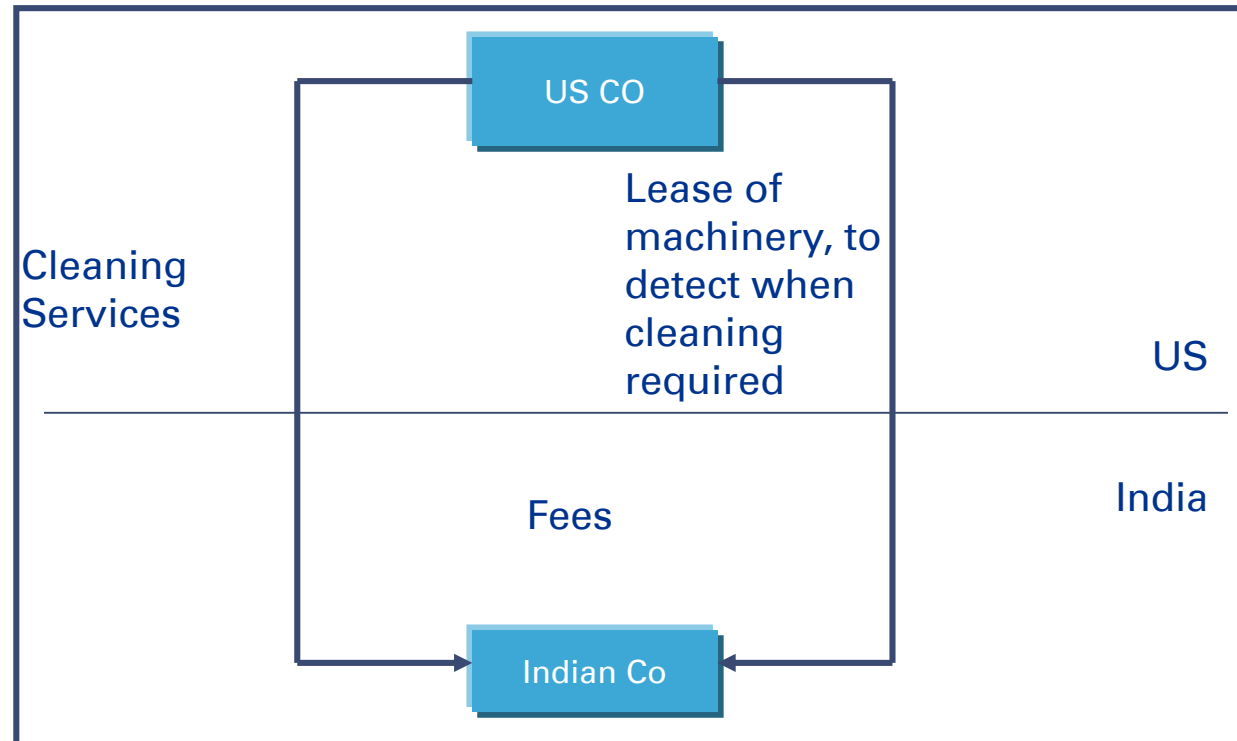
Meaning of “make available”

Typical categories of services that generally involve either the development and transfer of technical plans or technical designs, or making technology available include:

1. Engineering services (including the subcategories of bioengineering and aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering)
2. Architectural services
3. Computer software development
4. Technical training

Examples from protocol to India-US treaty...

Cleaning services
with lease of
equipment



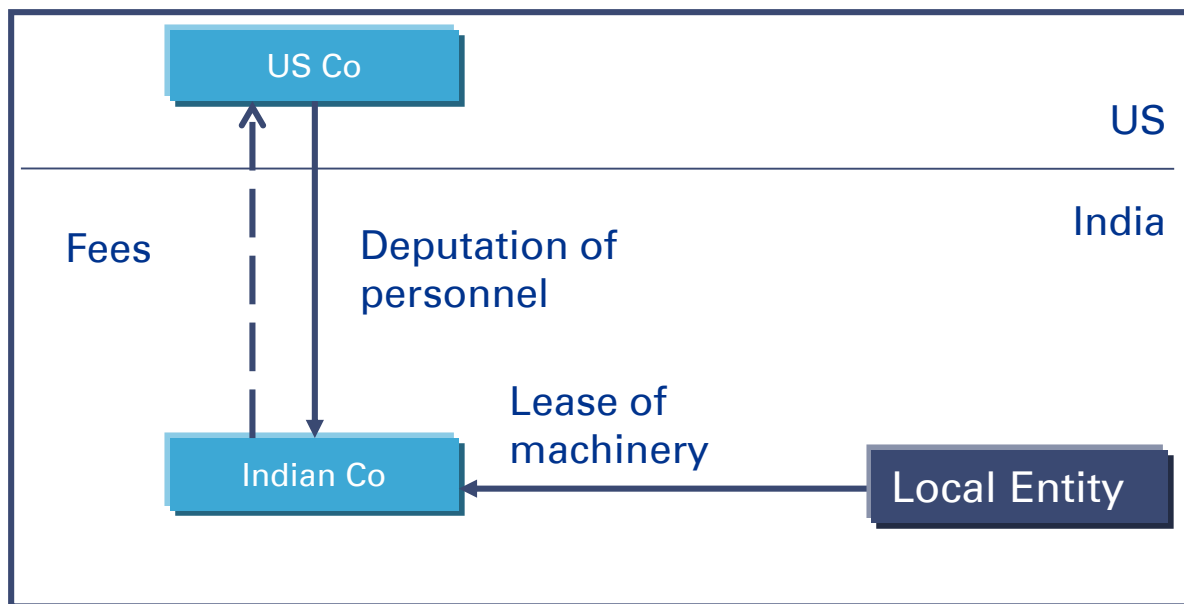
Though the cleaning services and the rental of the equipment are related, predominant purpose of the arrangement is provision of cleaning services; they are not ancillary and subsidiary to the rental of the equipment.

Hence the cleaning services cannot be regarded as FIS.

...Examples from protocol to India-US treaty...

Deputation of personnel

- An Indian builder rents a plant locally for manufacture of wallboards;
- It contracts with a US Co to send experts to India to show engineers in the Indian Co how to produce a extra-strong wallboard



Analysis

The services of the personnel of the US Co fulfill both requirements of Article 12(4):

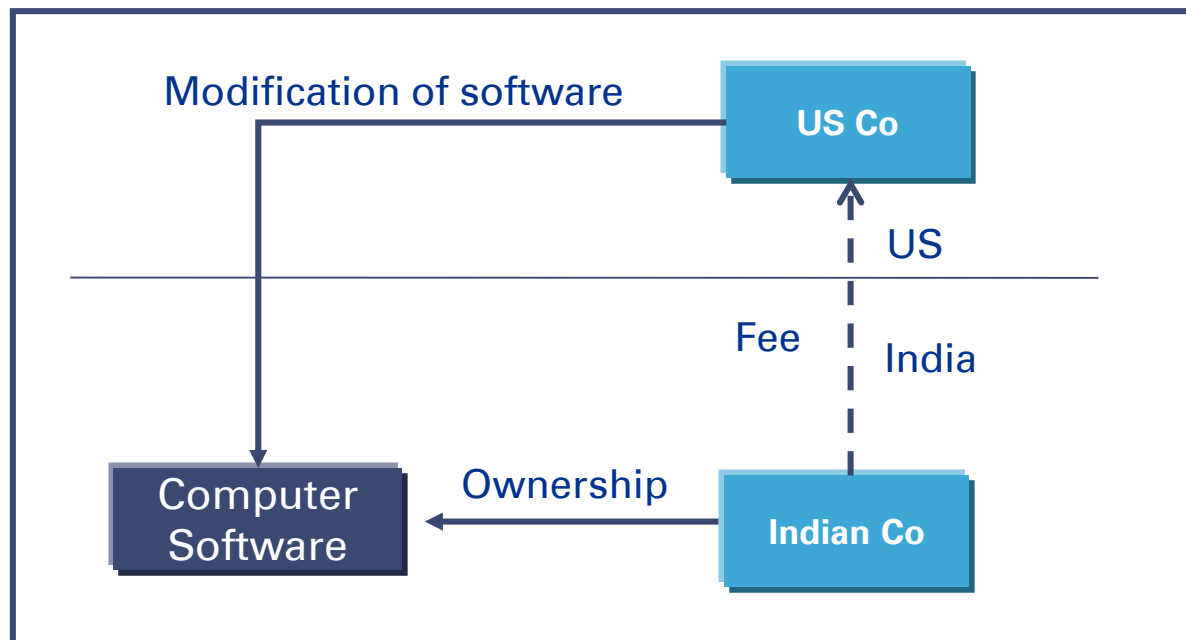
- The services are technical or consultancy in nature;
- They make available to the Indian company technical knowledge; skill, and processes.

Hence, payments will be regarded as FIS

...Examples from protocol to India-US treaty

Modification of computer program

- US company provides services relating to modification of computer software owned by an Indian Company and transfers technical plan as developed



Analysis

- US Co performs technical service for the Indian Co;
- US Co also transfers the technical plan (i.e. the computer program) which it modifies/develops.

Hence payment regarded as FIS

Interplay between Articles of the treaty

In absence of Article on FTS in DTAA, whether the income is taxable under DTAA? If yes, whether as 'Business profits' or 'Other income'

Whether Article on Service PE overrides Article 12?

It is possible that FTS might also include professional services. In such context, whether Article 12 would apply or would Article 15 has precedence?

What if equipment royalty is not included article of 'Royalty'?

Whether Tax payer can offer income to tax under the provisions of the Act for one contract and provisions for tax treaty under different contract?

Most Favored Nation (MFN) Clause



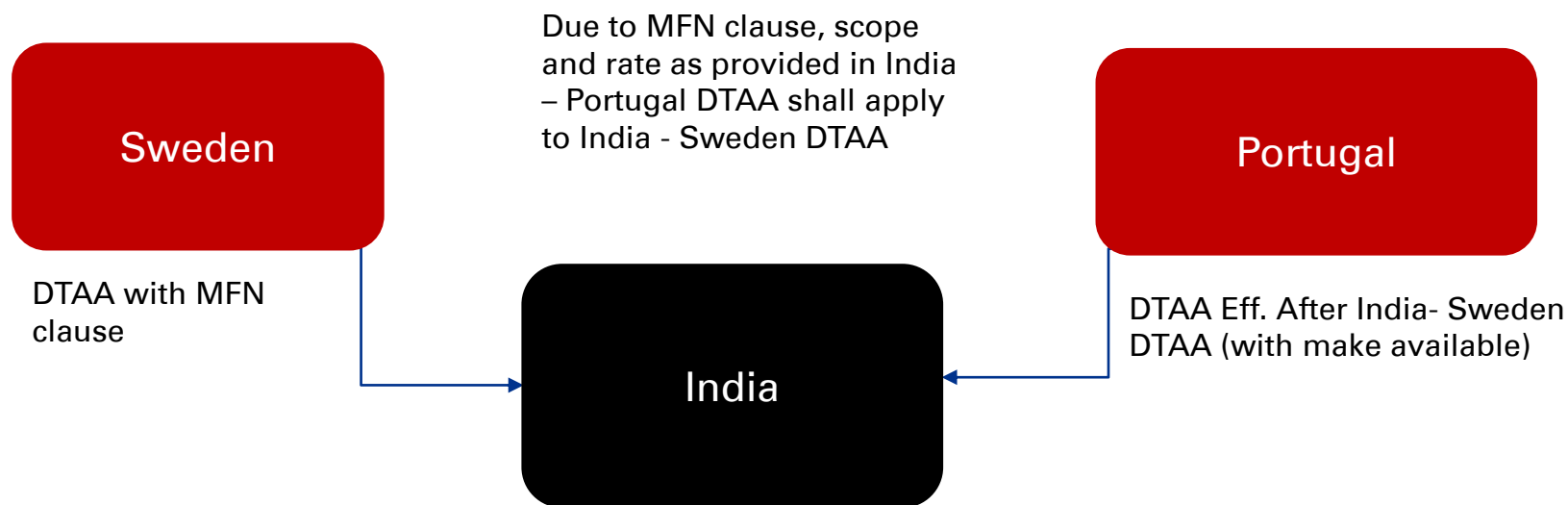
Most Favored Nation Clause

- Normally benefit under this clause is restricted to a specific group like OECD countries or developing countries
- Benefit provided is normally with respect to following:
 - Rates of taxes
 - Liability to tax
 - Deductions permissible
- Attempts to avoid discrimination between residents of different countries
- MFN clause usually found in Protocols and Exchange of notes
- Ensures equal treatment between a subset of countries
- Extends similar benefits to one country as extended to certain other countries

Most Favored Nation Clause

- Applying the MFN Clause

Example: In a MFN situation, generally, one of the contracting states (say India) to the DTAA grants the residents of the other contracting state (say Sweden), the same beneficial treatment made available by it (that is, by India) to the resident of a third country (say Portugal) with whom it has entered into a DTAA



Thank You

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