

May 15, 1989

U.S. - INDIA TAX TREATY

**Memorandum of understanding concerning  
fees for included services  
in Article 12**

*Paragraph 4 (in general)*

This memorandum describes in some detail the category of services defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services). It also provides examples of services intended to be covered within the definition of included services and those intended to be excluded, either because they do not satisfy the tests of paragraph 4, or because, notwithstanding the fact that they meet the tests of paragraph 4, they are dealt with under paragraph 5. The examples in either case are not intended as an exhaustive list but rather as illustrating a few typical cases. For ease of understanding, the example in this memorandum described U.S. persons providing services to Indian persons, but the rules of Article 12 are reciprocal in application.

Article 12 includes only certain technical and consultancy services. But technical services, we mean in this context services requiring expertise in a technology. By consultancy services, we mean in this context advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

Under paragraph 4, technical and consultancy services are considered included services only to the following extent: ( 1) as described in paragraph 4( a), if they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or ( 2) as described in paragraph 4( b), if they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, under paragraph 4( b), consultancy services which are not of a technical nature cannot be included services.

*Paragraph 4(a)*

Paragraph 4(a) of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3( a) or ( b) is received. Thus, paragraph 4(a) includes a technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of an intangible for which a royalty is received under a license or sale as described in paragraph 3(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment for which a royalty is received under a lease as described in paragraph 3(b).

It is understood that, in order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3(a) or ( b) is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payments are made must be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the service is related to the application or enjoyment of right, property, or information described in paragraph 3 and whether the clearly predominant

purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include :

1. The extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3 ;
2. The extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3 ;
3. Whether the amount paid for the services (or which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3 ;
4. Whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts) ; and
5. Whether the person performing the services is the same person as, or a related person to, the person receiving the royalties described in paragraph 3 [for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the service is doing so in connection with an overall arrangement which includes the payer and recipient of the royalties].

To the extent that services are not considered ancillary and subsidiary to the application or enjoyment of some right, property, or information for which a royalty payment under paragraph 3 is made, such services shall be considered "included services" only to the extent that they are described in paragraph 4(b).

#### Example 1

##### Facts :

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process, patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payment allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services" ?

##### Analysis :

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of manufacturing process protected by law as described in paragraph 3(a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible as the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered for included services under paragraph 4(a) of Article 12, regardless of whether the services are described in paragraph 4(b).

#### Example 2

##### Facts :

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing such deposits from that type of machinery. The U.S. company enters into a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services ?

##### Analysis :

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4(a).

#### Paragraph 4(b)

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the services, technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plant or technical design to such person. (For this purpose, the person acquiring the services shall be deemed to include an agent, nominee, or transferee of such person). This category is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc., are made available to the person purchasing the service, within the meaning of paragraph 4(b). Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plants or technical designs, or making technology available as described in paragraph 4(b), include :

1. Engineering services (including the sub-categories of bio-engineering and aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering) ;
2. Architectural services ; and
3. Computer software development.

Under paragraph 4(b), technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for examples, relate to any of the following areas :

1. Bio-technical services ;

2. Food processing ;
3. Environmental and ecological services ;
4. Communication through satellite or otherwise ;
5. Energy conservation ;
6. Exploration or exploitation of mineral oil or natural gas ;
7. Geological surveys ;
8. Scientific services ; and
9. Technical training.

The following examples indicate the scope of the conditions in paragraph 4(b) :

*Example 3*

*Facts :*

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services" ?

*Analysis :*

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill and processes.

*Example 4*

*Facts :*

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services ?

*Analysis :*

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plan or design. The U.S. company is merely performing a contract manufacturing service.

*Example 5*

*Facts :*

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to assess the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services ?

*Analysis :*

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (*i.e.*, the computer programme) which it has developed.

*Example 6*

*Facts :*

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services ?

*Analysis :*

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

*Example 7*

*Facts :*

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product worldwide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services ?

*Analysis :*

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

*Paragraph 5*

Paragraph 5 of Article 12 describes several categories of services which are not intended to be treated as included services even if they satisfy the tests of paragraph 4. Set forth below are examples of cases where fees would be included under paragraph 4, but are excluded because of the conditions of paragraph 5.

*Example 8*

*Facts :*

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also, as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

*Analysis :*

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore, are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

*Example 9*

*Facts :*

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training and warranty service is relatively minor as compared with the cost of the X-ray machine. Is any of the services described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine?

*Analysis :*

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on the service, the manufacturer has full responsibility during this period and this cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the X-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the tests of paragraph 4(b).

*Example 10*

*Facts :*

An Indian automobile manufacturer decides to expand into the manufacturer of helicopters. It sends a group of engineers from its design staff to a course of study conducted by the Massachusetts Institute of Technology (MIT) for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

*Analysis :*

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpose whether MIT conducts the course on its campus or at some other location.

*Example 11*

*Facts :*

As in Example 10, the automobile manufacturer wishes to expand into the manufacturer of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

*Analysis :*

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

*Example 12*

*Facts :*

An Indian wishes to install a computerized system in his home to control lighting, heating and air-conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring

system, adapt standard software, and provide instructions for installations. Are the fees paid to the American firm by the Indian individual fees for included services ?

*Analysis :*

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

#### **Indo-US Double Taxation Avoidance Convention (DTAC) - Suspension of Collection during Mutual Agreement Procedure**

Article 27 of the Indo-USA DTAC provides for Mutual Agreement Procedure (MAP) for avoidance of double taxation. Paragraph 4 of article 27 authorises the competent authorities to develop appropriate bilateral procedures, conditions, methods and techniques for implementation of MAP provided for in the article. Accordingly, with a view to avoid the unintended hardship to the taxpayers, as well as for the efficient management of collection of revenue, the Competent Authorities of India and USA had entered into a Memorandum of Understanding (MoU) regarding suspension of collection during the pendency of MAP.

2. This MoU was brought to the notice of field formation *vide* Instruction No. 2/2003, dated 28-4-2003 (F. No. 500/56/99-FTD) wherein it was stated that the collection of outstanding taxes in the case of a taxpayer, who is a resident of USA and whose request under MAP is under consideration of the Competent Authorities, shall be kept in abeyance subject to furnishing of a bank guarantee of an amount equal to the amount of tax under dispute and interest accruing thereon as per the provisions of the Income-tax Act.

3. Now references have been received for extending the applicability of MoU to Indian resident entities in cases where Mutual Agreement Procedure has been invoked by the US resident. In order to avoid hardship to Indian resident taxpayers especially in cases involving transfer pricing, where the Indian resident entity is liable to pay taxes on such income which may have been charged to tax in the hands of the associated entity in USA, it has been decided to extend the applicability of the MoU to such Indian resident entities during the course of the pendency of the MAP invoked by a resident of USA.

4. On receipt of a formal request for suspension of collection of outstanding tax in terms of the MoU from a taxpayer being, a resident of USA or an Indian resident entity, in a case where MAP has been invoked through US Competent Authority and the same has been admitted by the Indian Competent Authority, the Assessing Officers are required to keep the enforcement of collection of outstanding taxes in abeyance in respect of such taxpayers—

- (i) after obtaining a confirmation regarding pendency of MAP from the Foreign Tax and Tax Research Division of the Central Board of Direct Taxes and
- (ii) on receipt of a bank guarantee in the model draft format annexed to the MoU for an amount calculated in accordance with the manner indicated therein.

5. All the other conditions of MoU as enumerated in Instruction No. 2 of 2003, dated 28-4-2003 shall remain the same.

6. These instructions are issued under section 119 of the Income-tax Act and the same may be brought to the notice of all the officers in your charge.

**Instruction : No. 10/2007, dated 23-10-2007.**