

Taxation of Fees for Technical Services and Royalties

This article discusses the controversial issue of the taxability of income as royalties or technical fees, both from the perspective of domestic law and tax treaties.

1. Introduction

The characterization and consequent taxation of income as “royalty” or “fee for technical services” (FTS) in India in the hands of a non-resident has been the subject matter of considerable litigation between taxpayers and the tax authorities.

Provisions of the Indian Income Tax Act 1961 (ITA) read with those of the applicable tax treaty would determine the taxability of an item of income as royalty or FTS, as the case may be, in India. There are various aspects to such a determination, for example, examining the scope of the relevant definitions both under the ITA as well as the relevant tax treaty for the purpose of ascertaining whether or not a particular income is royalty or FTS; if none of the definitions are satisfied, how would the income be characterized for taxation purposes, i.e. whether such income will then be regarded as “Business Profits” or “Other Income”, etc. This article deals with such important aspects while providing an insight into some commonly arising disputes in the context of taxability of income as royalty or FTS.

2. Legislation Governing the Taxation of Royalty and FTS

Section 5 of the ITA, which defines the scope of taxable income of a non-resident in India, inter alia provides that such taxable income of a non-resident shall include income which is deemed to accrue or arise in India. The deeming source rule of taxation is contained under section 9 of the ITA which inter alia contains the deeming provisions regarding the accrual of royalty and FTS in India.

2.1. Royalty

2.1.1. Meaning under the ITA

The ITA¹ defines royalty in an exhaustive manner as a consideration (excluding any consideration which results in income chargeable as capital gains) for:

– Use of, – Transfer of all or any rights (including granting of a licence) in respect of, – Imparting of any information concerning the working of, or the use of,	any patent, invention, model, design, secret formula or process or trademark or similar property
– Imparting of any information concerning,	any technical, industrial, commercial or scientific knowledge, experience or skill
– Use or right to use,	any industrial, commercial or scientific equipment
– Transfer of all or any rights (including granting of a licence) in respect of,	any copyright, literary, artistic or scientific work including films or videotapes 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

The Finance Act 2012 introduced certain significant amendments widening the scope/definition of royalty. These amendments have been introduced by way of clarifications and made effective retrospectively from 1 June 1976. The following is a gist of these amendments.

Computer software

It has been clarified that the transfer of all or any rights in respect of any right, property or information includes the transfer of all or any right for use or right to use computer software (including the granting of a licence).

Consequent to this clarification, payments towards off-the-shelf software would also be taxable as a royalty in the hands of a non-resident seller, and the buyer would be under an obligation to withhold applicable taxes for royalties from the purchase price.

This amendment seeks to set at rest the debate of transfer of a “copyright” versus a “copyrighted article” for the purpose of characterizing income as royalty. However, the provisions of the applicable tax treaty would also be critical in order to ascertain if supply of such software could be treated as giving rise to a royalty.

The Central Board of Direct Taxes (CBDT) vide a notification² provided that with effect from 1 July 2012, no deduction of tax will be made on the payment by a person

* © Sanjay Sanghvi and Ritu Shaktawat. Sanjay Sanghvi is a Partner with Khaitan & Co, Mumbai, India while Ritu Shaktawat is a Senior Associate at the firm. They may be contacted at sanjay.sanghvi@khaitanco.com and ritu.shaktawat@khaitanco.com respectively.

1. Explanation 2 to section 9(1)(vi) of the ITA.

2. CBDT Notification No. 21 of 2012.

(transferee) for acquisition of software from a resident (transferor) if:

- the software is acquired in a subsequent transfer and the transferor has transferred the software without modification;
- the applicable tax (either under section 194J or 195 of the ITA) on the payment has been deducted for any previous transfer of such software; and
- the transferee obtains a declaration from the transferor that tax has been deducted, along with the Permanent Account Number of the transferor.

This notification seeks to ensure that there is no cascading effect of the amendment in case of pure distributorship arrangements where tax has already been deducted with respect to the purchase of software and the same software without any modification is further sold by a resident in India.

Transmission by satellites

It has been clarified that the term “process” includes transmission by satellite (including uplinking, amplification, conversion for downlinking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret.

There has been considerable litigation in relation to the source of income arising to satellite operators from Indian channels/cable television operators or where signals are transmitted to Indian territory while none of the television channel operators and satellite operators are in India. The amended provision, thus, makes the argument taken by the taxpayers, that no secret process is involved in such arrangements, redundant. Accordingly, income from such operations would be taxable in India as royalty under the ITA. However, the provisions of the applicable tax treaty would also be relevant in determining their taxability.

2.1.2. Meaning under tax treaties

Most of India’s tax treaties contain more or less a similar definition of royalty except the aforesaid amendments and some variations. For example:

- India’s tax treaties with Belgium, France, Greece, Israel, Kazakhstan, the Netherlands, Spain and Sweden, do not regard considerations for use of industrial, commercial or scientific equipment as royalty; and
- India’s tax treaties with Morocco, Russia, Trinidad and Tobago, Turkmenistan and some others specifically regard payments for the use of or the right to use computer software as royalty.

2.2. FTS

2.2.1. Meaning under the ITA

The ITA defines FTS as any 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 as “Salaries”.

Managerial, technical and consultancy services

Managerial, technical and consultancy services are neither defined under the ITA nor under tax treaties. Thus, their meaning as understood in commercial parlance and as interpreted judicially would serve as a guide.

Managerial services

The Oxford Dictionary³ defines “manager” as:

... 4. A person who manages an organization, business establishment, or public institution, or part of one; a person with a primarily executive or supervisory function within an organization etc.

The term “manage” in the Oxford Dictionary⁴ is defined as:

... 3. Conduct or carry on (a war, business, an undertaking, an operation); control the course of (affairs) by one’s own action; control and direct the affairs of (a household, institution, state, etc.); be a manager of (a team etc.); take charge of, attend to (cattle, etc.)

Thus, managerial services may be taken to mean the rendering of services involving controlling, directing, managing or administering any business activity. Services towards the adoption and carrying out of policies of an organization and for management of affairs⁵ have been held to be managerial services.

Technical services

The Oxford Dictionary⁶ defines “technical” as:

... A.2. Pertaining to, involving, or characteristic of a particular art, science, profession, or occupation, or the applied arts and sciences generally.

Technical service would mean a service which would require an expertise in technology.⁷ Services are said to be technical when special skill or knowledge relating to a technical field is required for the provision of such services.⁸ In a case⁹ which is widely relied upon for guidance on the meaning of technical service, the Madras High Court had observed that “technical service” as referred to in section 9(1)(vii) of the ITA contemplates the rendering of a “service” to the payer of the fee. Mere collection of a fee for the use of a standard facility provided to all those willing to pay for it does not amount to the fee having been received for technical services.

Consultancy services

The Oxford Dictionary¹⁰ has defined “consult” by saying that to consult is to:

-
3. Shorter Oxford English Dictionary, Sixth Edition, 2007 (Deluxe), Volume 2.
 4. Id.
 5. *Linde AG v. ITO*, (1997) 62 ITD 330 (Mum); *eBay International AG v. ADIT*, (2012) ITA No. 6784/M/2010.
 6. *Supra* n. 3.
 7. Memorandum of Understanding to the India-United States tax treaty.
 8. *eBay International AG v. ADIT*, (2012) ITA No. 6784/M/2010.
 9. *Skycell Communications Ltd. and another v. DCIT and others*, 251 ITR 53.
 10. Shorter Oxford English Dictionary, Sixth Edition, 2007 (Deluxe), Volume 1.

2. Confer about, deliberate upon, consider; 3. Ask advice of, seek counsel or a professional opinion from; refer to (source of information); seek permission or approval from for a proposed action.

Therefore, consultancy services would mean services of an advisory nature. A consultancy service could also be a technical service in certain cases.¹¹ However, expertise in technology is not essential while providing consultancy services.¹²

2.2.2. Meaning under tax treaties

Most of the India's tax treaties define FTS as a consideration for managerial, technical or consultancy services while in some of the other tax treaties, the definition of FTS does not expressly include managerial services (e.g. treaties with Canada, Portugal, the United Kingdom (UK) and the United States (US)).

Some of India's tax treaties contain the concept of "make available" such as its treaties with Australia, Canada, Cyprus, Malta, the Netherlands, Singapore, the UK and the US. In some other tax treaties with countries such as Belgium, France and Spain, the scope of FTS could be narrowed down to include the "make available" clause by virtue of the protocol contained therein.

Certain of India's tax treaties such as those with Canada and the US having the "make available" clause, use the term "fees for included services" (FIS), while others use the term FTS. The "make available" concept narrows down the scope of FTS to mean payments in consideration for the rendering of any technical or consultancy services only if such services:

- are ancillary and subsidiary to the application of a right, property or information for which royalty is received; or
- "make available" technical knowledge, experience, skill, know-how, or processes, or consist of development and transfer of a technical plan or technical design.

Thus, the concept of "make available" limits the scope of taxability of FTS to a great extent. Not every technical service would make available technology, skill or experience of the service provider to the service recipient. In general terms, a service can be said to make available the technology, skills, knowledge or experience by the service provider to the service recipient if the latter is able to apply such technology, skills and experience on its own and without recourse to the service provider.

India and the US have signed a Memorandum of Understanding¹³ (MoU) which provides significant guidance as regards the interpretation of the "make available" condition. As per the MoU, 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

-
11. Memorandum of Understanding to the India-US tax treaty.
 12. Memorandum of Understanding to the India-US tax treaty; Technical Explanation to the India-US tax treaty; Technical Explanation to the India-Australia tax treaty.
 13. MoU concerning FIS in article 12.

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. Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available. The MoU also contains certain examples to elaborate upon the "make available" concept.

It is important to note that the concept is explained only in the MoU and not any other tax treaty containing the make available clause. Therefore, an issue may arise as to whether the reasoning and examples contained in the MoU could be relied upon in the context of other tax treaties containing the "make available" concept as well.

In various cases,¹⁴ such reliance has been accepted. At the same time, it is pertinent to note that the Income Tax Appellate Tribunal (ITAT) in a case¹⁵ did not accept reliance on the MoU for the purpose of interpretation of the India-UK tax treaty provisions. The ITAT rather observed that in the absence of any definition, the meaning to the term under the ITA should be adopted.

In another case,¹⁶ the Authority for Advance Rulings (AAR)¹⁷ in India ruled that payments made towards services in the field of accounting, budgeting, sales, marketing, foreign exchange management, loans, human resources, legal support, etc. are technical in nature and they also "make available" technical knowledge, experience and thus are taxable as FTS under the India-Netherlands tax treaty. The AAR further observed that the expression "make available" would indicate that the recipient of the service should be in a position to derive an enduring benefit and should be in a position to utilize the knowledge in future on his own.

Further, as regards the interpretation of the India-Netherlands tax treaty on the basis of the MoU Protocol to the India-US tax treaty, the AAR observed the protocol attached to a treaty between two countries could be examined to ascertain the meaning of an expression used in that particular treaty, but to refer to a treaty to which two countries are not parties, would not be appropriate. Therefore, no inference as to the meaning of "make available" could be drawn from the India-US treaty while interpreting the terms of the India-Netherlands tax treaty. This view taken by the AAR deviates from the view taken by other Courts and AAR's own view in some other cases. This coupled with the non-binding nature of rulings of the AAR dilutes the relevance of this ruling for other cases.

-
14. *Raymond v. DCIT*, (2003) 86 ITD 791 (Mum); *DCIT v. Boston Consulting Group Pte. Limited*, (2005) 94 ITD 31 (Mum); *ITO v. De Beers India Minerals (P) Ltd*, (2008) 113 TTJ 101 (Bang); In re. *Anapharm Inc*, (2008) 305 ITR 394 (AAR); In re. *Intertek Testing Services India Pvt Ltd*, (2008) 307 ITR 418 (AAR).
 15. *ONGC v. ACIT*, (2006) 9 SOT 8.
 16. In re. *Perfetti Van Melle*, (2011) AAR/869/2010.
 17. Rulings pronounced by the AAR are facts specific and not binding precedents. However, they do have persuasive value in similar facts and circumstances.

Some recent decisions on the “make available” concept

Recently, the Delhi High Court¹⁸ examined the scope of the “make available” concept and held that to make available technical knowledge, mere provision of service is not enough, i.e. the payer must be enabled to perform the service himself. The Court referred to a decision¹⁹ of the ITAT which had examined the connotations of the “make available” concept in the context of the India-UK tax treaty and observed that the mere rendering of services is not roped in as FTS unless the person utilizing the services is able to make use of the technical knowledge, experience, skills, know-how or processes by himself in his business or for his own benefit and without recourse to the performer of the services in future. The fruits of the services should remain available to the person utilizing the services, even after the rendering of the services has come to an end, in some concrete shape such as technical knowledge, experience, skills, know-how or processes.

In another recent case,²⁰ the ITAT in the context of the India-Singapore tax treaty held that the services rendered by the foreign company being simply in the nature of consultancy services that did not make available any technology would not qualify as FTS. In the absence of a permanent establishment (PE) of the foreign company in India, the fees paid being in the nature of business profits are not taxable in India. The ITAT further held that the fees will not be taxable under the “Other Income” article of the tax treaty, as taxability of FTS is covered by a specific article and merely because it cannot be taxed there, it will not be taxable under the “Other Income” article in the tax treaty.

2.3. Taxation of FTS and royalty

Since a taxpayer may choose²¹ to be governed by the provisions of the ITA if the same are more beneficial than those of the relevant tax treaty, it is important to ascertain whether the taxpayer is better off by opting to be governed by the tax treaty. There is a possibility of an income falling within the scope of royalty or FTS under the ITA, while it may not fall within the scope of royalty or FTS under the applicable tax treaty. In those cases, such income would not be taxable in India provided that the recipient does not have a PE in India.

Where the recipient has a PE in India, the income would be taxable in India as business income whether or not such income qualifies as royalty or FTS. Such taxability would be restricted to the extent the income is attributable to or is effectively connected to the PE in India. An issue as to the characterization of income arises where neither the income qualifies as royalty/FTS nor the non-resident recipient has a PE in India. In such cases, it needs to be ascertained if the income can be brought to tax in India as income from other sources depending upon the provisions of the applicable tax treaty. Generally, the tax treaty

articles dealing with “Other Income” assign the right to tax such income to the source state or as per the respective domestic laws of the two contracting states.

2.3.1. Gross and net basis of taxation

Royalty and FTS are taxed on a gross basis, i.e. without allowing deduction for any expenditure that may have been incurred for the purpose of earning such income. However, where the non-resident has a PE in India and the royalty/FTS is attributable to the PE, then the income is taxable on a net basis, i.e. after allowing deductions for expenses.²²

2.3.2. Rate of tax

Where payments constitute royalty/FTS under the ITA as well as under the tax treaty and the non-resident does not have a PE in India, for agreements entered into on or after 1 June 2005, the ITA prescribes a tax rate of 10%²³ for royalty as well as FTS.

However, in case of agreements entered into before 1 June 2005, the non-resident may generally opt for the rate of tax prescribed under the tax treaty where the same is lower than the rate under the ITA of 20%. Where the non-resident has a PE in India, the rate of tax applicable to business profits would be applicable which is 42.024%²⁴ in case of a foreign company.

2.3.3. Source of royalty/FTS: ITA and tax treaties

As per the ITA, for the purpose of determining source of royalty or FTS, it is not necessary that service be rendered in India.²⁵

Payments from a resident to a non-resident

Royalty or FTS payable by a resident shall be deemed to accrue or arise in India except where it is payable in respect of any right, property, etc. or services utilized for the purpose of/in business or profession carried on by such resident outside India or for the purposes of making or earning any income from any source outside India. This exception has been the subject matter of litigation as far as its applicability is concerned. Typically, disputes have arisen with respect to export business activities of Indian residents.

In this regard, reference may be made to a recent ruling of the Delhi High Court²⁶ dealing with the issue of whether payments made by an Indian company to a non-resident for certification services in connection with export sales would be taxable in India as FTS. The High Court ruled that the source of income from certification services was an export activity which was undertaken and fulfilled by the Indian company in India. The source of income is

18. *DIT v. Guy Carpenter & Co Ltd*, (2012) ITA No. 202/2012 (Del).

19. *See Raymond v. DCIT*, n. 14.

20. *DCIT v. Andaman Sea Food Private Limited*, (2012) TII-67-ITAT-KOL-INTL.

21. As per section 90(2) of the ITA.

22. As per section 44DA of the ITA, payments by a PE to the foreign entity/head office/other offices are not allowed as deduction.

23. To be further increased by applicable surcharge and education cess.

24. Inclusive of surcharge and education cess.

25. Explanation to section 9 of the ITA.

26. *CIT v. Havells India Ltd.*, (2012) VAD (Delhi) 755.

created at the moment when the export contracts are concluded in India and, hence, income from certification services was held to be taxable in India. However, in another case,²⁷ the Court held the source of income to be outside India where the royalty/fee was paid out of the export sales.

Payments from a non-resident to another non-resident

Under the ITA, royalty or FTS payable by a non-resident shall be deemed to accrue/arise in India if it is payable in respect of any right, property, etc. or services utilized for the purpose of/in business or profession carried on by such non-resident in India or for the purpose of making or earning any income from any source in India. Generally, tax treaties restrict the taxability in India of royalty/FTS from one non-resident to another only to cases where the payer has a PE in India in connection with which royalty/FTS is incurred and the same are borne by the PE. Thus, where a tax treaty is applicable, the existence of a PE in India would be the basis for taxation in India of the royalty paid by one non-resident to another.

3. Recent Controversies and Challenges for Taxpayers

While dealing with the disputes regarding characterization of income, Courts generally recognize that it is the true nature of the consideration and not the nomenclature of an agreement which is determinative of the nature of income.²⁸ The following discussion seeks to highlight some of the areas of dispute and the judicial views thereon.

3.1. Computer software and satellite transmissions

There have been disputes regarding the characterization of income from sales of computer software and satellite transmissions as royalty income. Such income characterization issues assume significance especially in light of the amendments introduced by the Finance Act 2012, which seek to overrule the decisions upholding the positions adopted by taxpayers. The following is a brief perspective of the controversies and recent judicial views on this issue.

Computer software

The Indian judicial position on the taxability of payments for software has been somewhat uncertain on account of some contradictory decisions. On the one hand, there are rulings which support the taxpayer's position recognizing the distinction between a "copyright" and a "copyrighted article". On the other hand, in some decisions, this distinction has been disregarded and the payment for copyrighted software has been treated as royalty.

Further, the amendment brought in by the Finance Act 2012 seeks to clarify that payments towards the use of or any rights in the computer software would be treated as

royalty. However, where a tax treaty is applicable, this may still not settle the controversy as the position under the tax treaty remains unchanged.

In this regard, reference may be made to a recent decision²⁹ of the Delhi High Court wherein it was held that payments made towards software embedded in telecommunication equipments would not be taxable as royalty in the hands of the non-resident recipient of income. This is because the amendments made to the definition of royalty under the ITA could not be read into the definition of royalty under the India-Finland tax treaty and the taxpayer had chosen to be governed by the provisions of the tax treaty.

The other two previous High Court decisions³⁰ are also representative of the controversy. The Karnataka High Court in the case of *Samsung Electronics Company Limited*³¹ had ruled that the software licence agreement, which essentially puts restrictions on the use of the software, amounts to transferring a licence to use the copyright belonging to the provider of software and thus held the payment towards software as being royalty. However, soon thereafter, there was a decision of the Delhi High Court in the case of *Ericsson Radio Systems*,³² in which the Court examined the taxability of payments for software which was embedded in the hardware that the Indian purchaser acquired. The Court held that no part of the payment for software could be classified as royalty. In another case,³³ the ITAT, relying upon the judgment of the Delhi High Court in the *Ericsson Case*, held that payments for standard/shrink-wrapped software cannot be said to be in the nature of royalties.

Satellites: Lease of transponder capacity

In this case,³⁴ the service fees received by the US company (i.e. the taxpayer) from non-resident television channels for use of its transponder to transmit signals to Indian viewers was held to be neither amounting to royalty nor FIS, as no secret formula or process was involved therein. In the context of the India-US tax treaty it was observed that there is a comma after the words "secret formula or process" which indicates that both the words "formula" and "process" are qualified by the word "secret". Thus, the requirement under the treaty is that both the formula and the process, for which the payment is made, should be a secret formula or a secret process in order for the consideration to be characterized as royalty. As mentioned in 2.1.1., the Finance Act 2012 clarifies that "process" includes transmissions by satellites, whether or not such process is secret. However, since tax treaties do not contain a similar provision or clarification, one would need to see how the tax authorities proceed with the application of this amendment.

27. *CIT v. Aktiengesellschaft Kuhnle Kopp and Kausch*, (2003) 262 ITR 513 (Mad).

28. In re. *P No 22 of 1996*, (1999) 238 ITR 99 (AAR); *ITO v. SMS Schloemann Siemag Aktiengesellschaft Dusseldorf*, (1996) 57 ITD 254 (Hyd); *Sheraton International Inc v. DDIT*, (2006) 10 SOT 542 (Del).

29. *DIT v. M/s Nokia Networks OY*, (2012) TS-700-HC-2012 (Del).

30. Decided before the enactment of the Finance Act 2012.

31. *CIT v. Samsung Electronics Co Ltd*, (2012) 345 ITR 494.

32. *DIT v. Ericsson A.B. Ericsson Radio System A.B. and Metapath Software International Ltd.*, (2012) 343 ITR 470.

33. *DDIT v. Solid Works*, (2012) ITA No 3219/MUM/2010.

34. *DCIT v. Panamsat International Systems Inc*, (2006) 103 TTJ 861 (Del).

The Delhi High Court³⁵ has held that no income could be deemed to accrue in India from the use of a satellite outside India to beam television signals into India and observed that in order to constitute royalty, the payer must have the right to control the equipment. A payment for a standard service would not constitute a royalty, merely because equipment was used to provide that service.

In another recent case,³⁶ while disregarding the aforesaid Delhi High Court decision in view of the retrospective amendment introduced by the Finance Act 2012, the tax authorities held that hire charges towards the hire of a transponder satellite were royalties. The ITAT held that despite such retrospective amendment, income would not be taxable as royalty since the applicable tax treaty would prevail. They rejected the tax authorities' argument that the amendments by the Finance Act 2012 change this position, since there is no change in the applicable tax treaty and the latter prevails where it is favourable to the taxpayer.

3.2. Credit rating services

There are contradictory decisions on the characterization of income from credit rating services. In one case,³⁷ payments to a specialized credit rating agency for credit rating services were held to be for professional services and the income was held to be business income of the non-resident company. Thus, it was not taxable in India in the absence of a PE in India.

In another case,³⁸ the issuance of a credit rating by a credit rating agency was held to be a supply of commercial information, and the annual surveillance fee falls within the category of ancillary services provided in connection with the supply of commercial information. Accordingly, it was held as taxable as FTS³⁹ in India.

3.3. Income from website operations

The ITAT in a recent case⁴⁰ involving a Switzerland-based website operator held that the fees received by the Swiss company from enabling sellers registered on its offshore website to sell goods to buyers in India are not taxable as FTS as it does not render any managerial, technical or consultancy services to the payers. The websites were held to be analogous to a market place where the buyers and sellers assemble to transact and that by providing a platform for doing business, the Swiss operator could not be said to be rendering any services either to the buyer or to the seller which can be taxed as FTS.

In the present-day world where virtual means of operations have significantly reduced the need for physical interface/presence, one would have to see the evolution of law on the aspect of taxation of electronic commerce.

35. *Asia Satellite Telecommunications Co v. DIT*, (2011) 332 ITR 340 (Del).
 36. *B4U International Holdings Ltd. v. DCIT (IT)*, (2012) ITA No. 3326/Mum/2006 (Mum ITAT).
 37. *Hindalco Industries Ltd v. ITO*, (2005) 96 TTJ 1009 (Mum).
 38. *Essar Oil Ltd v. JCIT*, (2006) 102 TTJ 270 (Mum).
 39. Under the India-Australia tax treaty, FTS is covered within the definition of "royalty" under article 12 and there is no separate article dealing with FTS.
 40. *Supra* n. 8.

Until then, this decision would be useful in the context of assessing taxability in the field of electronic commerce where a foreign website operator's role is limited to providing a platform in the electronic space to the Indian buyers and sellers for transacting in goods.

3.4. Loan appraisal fees

The High Court of Bombay⁴¹ has held that appraisal fees received by a company in the UK from prospective borrowers is business profits and is taxable in India only if the foreign company has a PE in India. It could not be characterized as FTS. As regards the FTS, the work performed by the taxpayer with respect to appraising the creditworthiness of a borrower was intended to ascertain whether the loan should be granted to the prospective borrower or not and the taxpayer is not rendering any technical service to the borrower by appraising the borrower. Therefore, the question of making available any technical knowledge does not arise and article 13 (Royalty) of the India-UK treaty would not be attracted.

3.5. Managerial fees

The High Court of Madras set aside a ruling delivered by the AAR in the case of *Verizon Data Services India Private Limited*.⁴² The AAR had held that managerial fees received by a resident of the US, are taxable as FIS despite the "make available" clause under the India-US tax treaty. The taxpayer filed a petition before the High Court of Madras against this ruling of the AAR which remanded the matter back to the AAR for a fresh consideration.

3.6. Human intervention: Key for technical services

In a case,⁴³ the Supreme Court dealt with the issue as to whether interconnect charges/access/port charges paid by a mobile telecommunications service provider to Bharat Sanchar Nigam Limited for the interconnection facility amounted to FTS. The Supreme Court remanded the case to the tax officer to ascertain as to whether any manual intervention is involved in the technical operations by which a mobile telecommunications service provider is given the interconnection facility. Thus, it evolves that involvement of human intervention is the key as far as technical services are concerned.

3.7. Export commission: Source of income with respect to export business

Depending upon the facts of each case, commission paid for identifying and procuring orders could be treated as FTS.⁴⁴ This is another area of dispute in view of the contradictory rulings and withdrawal of CBDT Circulars⁴⁵ which expressly provided for non-taxability of commission payments to non-resident agents outside India in certain cases. The payments for export commissions to

41. *DIT v. Commonwealth Development*, (2012) Income Tax Appeal No. 1058 of 2011.
 42. (2011) 337 ITR 192 (AAR).
 43. *CIT v. Bharti Cellular Ltd.*, (2011) 330 ITR 239.
 44. *Wallace Pharmaceuticals Pvt Ltd.*, (2005) 278 ITR 97 (AAR).
 45. Circulars No. 23 dated 23 July 1969 and No. 786 dated 7 February 2000.

agents outside India, although they technically may not qualify as FTS, are at a high risk of being treated so by the tax authorities, especially in the wake of the withdrawal of the Circulars. Therefore, one may take a conservative stand depending upon the terms between the parties, risk assessment and ability to defend the stand adopted.

3.8. Secondment of employees

The arrangements involving secondment of personnel from a foreign entity to an Indian group entity remain an area of considerable litigation.

As a common practice in such arrangements and in view of practical realities, the expatriate secondees continue to receive their salaries in their home country from the foreign entity. The salary is then reimbursed by the Indian entity to the foreign entity. The taxability of such reimbursements is an area of dispute. Such reimbursements are generally treated as FTS by the tax authorities on the basis that the foreign entity is rendering technical services to the Indian entity to which the employees are seconded. As a result, the Indian entity is proceeded against for non-compliance with its withholding tax obligation. Such a treatment leads to double taxation of the same income, once in the hands of the employees as their salary income for employment exercised in India and then in the hands of the foreign entity as FTS received from the Indian entity. Therefore, it is critical to structure such arrangements appropriately. In certain cases,⁴⁶ relief was granted at the appellate level by rejecting such treatment of reimbursements as FTS.

3.9. Reimbursement of expenses incurred in the course of rendering services

This is also an area of dispute and which lacks clarity. An issue often arises on whether reimbursements by the service recipient of out-of-pocket expenses, such as airfare, lodging and boarding, etc., which are incurred by the service provider in the course of rendering services are taxable as FTS.

Generally, tax authorities treat such reimbursements as part of the fees for services and insist upon withholding tax from such reimbursements. Depending upon the facts, it could be contended that the reimbursements are not taxable, although Courts have also held to the contrary. Expenses on airfare, lodging, etc., which are incurred by the service recipient directly and not reimbursed to the service provider and in respect of which adequate evidence is furnished before tax authorities, are not FTS since there is no benefit derived by personnel of the service provider.

Therefore, one may be careful as far as this aspect is concerned. The risk can be mitigated by minimizing the quantum of reimbursements or ensuring appropriate/robust documentation such as separate invoices for pure reimbursements.

46. *Abbey Business Services (India) P. Ltd. v. DCIT*, (2012) ITA No. 1141 (Bang)/2010 and 41 & 42 (Bang)/2011; *ITO v. Ariba Technologies (India) Pvt. Ltd.*, (2012) ITA No. 616 (Bang)/2011.

3.10. Other significant aspects

Taxability in the year of receipt: Payment basis and not accrual basis for taxability

Tax treaties use the expression “royalties/FTS arising in a Contracting State and paid to a resident of another Contracting State”, in view of which, it has been held in various cases⁴⁷ that the taxability of royalty/FTS arises in the year of receipt and not in the year of accrual. Recently, the Bombay High Court⁴⁸ also upheld a receipt basis for taxation of royalty and FTS.

However, as per section 195 of the ITA, once the income in the hands of a non-resident is taxable in India (irrespective of the year of taxability of such income), the payer is required to withhold applicable tax at the earlier of the credit of income to the account of the payee (by way of book entry) or actual payment. Therefore, there may be cases where the year of actual taxability and withholding may be different. This may result in practical difficulties for the non-resident recipient in claiming the credit for the tax already withheld but in a different financial year.

FTS versus professional income

Some tax treaties contain a specific article dealing with independent personal services, which covers professional services and other activities of an independent character. For this purpose, professional services are defined in an inclusive manner and include independent scientific, literary, artistic, educational activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, accountants etc. Hence, professional services may very well fall within the scope managerial, technical or consultancy services.

Generally, the definitions of FTS/FIS specifically exclude payments made for independent personal services. Thus, if professional services are not taxable in the source country as per article 14 (dealing with independent personal services) then they cannot be taxed as per article 12 (dealing with FTS⁴⁹).

When not royalty/FTS: Other income or business income?

In a recent ruling,⁵⁰ the ITAT held that merely because the India-Mauritius tax treaty is silent on the taxability of FTS, it cannot be construed that the income will automatically be taxable as business income and in such a situation one has to consider and apply the provisions of the ITA.

For determining taxability of income from services in a case where the applicable tax treaty does not have a specific provision dealing with FTS, a reasonable view would be to determine taxability under the general provisions dealing

47. *National Organic Chemical Industries v. DCIT*, (2006) 96 TTJ 765 (Mum); *DCIT v. Uhde Gmbh*, (1996) 54 TTJ 355 (Mum); *CSC Technology Singapore Pte. Ltd.*, (2012) ITA No. 5604/Del/2010.

48. *DIT v. M/s Siemens Aktiengesellschaft*, (2012) ITA No. 124 of 2010.

49. *Graphite India Limited v. DCIT*, (2003) 86 ITD 384; *Dieter Eberhard Gustav Von Der Mark v. CIT*, (1999) 235 ITR 698 (AAR); *Maharashtra State Electricity Board v. DCIT*, (2004) 83 TTJ 325 (Mum).

50. *DCIT v. TVS Electronics Ltd*, (2012) TS-421-ITAT-2012.

with business income or other income. However, the ITAT in the aforesaid decision has disregarded the applicability of the tax treaty in its entirety. One would, thus, need to see how tax authorities would apply this decision.

Application of retrospective amendments

Although there are favourable recent rulings upholding non- applicability of retrospective amendments where

treaties apply, the tax authorities are likely to apply the same and determine taxability accordingly. This risk must be considered by taxpayers, especially those who could be targets of the tax authorities for non-compliance with their alleged withholding tax obligations.

4. Conclusion

The characterization of income is a factual and complex determination and cases involving payments which could be characterized as royalty or FTS are prone to litigation.

In the case of payments to non-residents, the implications get compounded in view of the two-fold impact, namely the withholding tax obligation of the payer and the taxability of income in the hands of the payee. Thus, one needs to take a proactive approach to ensure that the document trail adequately captures the intent, such that the position adopted by the taxpayers can be defended.

On the positive side, there are structuring opportunities available to non-residents rendering

services in India and having a presence in countries with which India has tax treaties containing the “make available” clause. This may result in income which would not be taxable in India in view of the narrower provision in these tax treaties for taxability of FTS. There could be a range of services falling outside the scope of taxability in India on account of a restricted provision. However, any such effort would need to be supported with adequate substance in that jurisdiction in order to satisfy anti-treaty shopping provisions in the applicable tax treaty and also in view of the proposed move to a “substance over form” driven approach to taxation as captured in the general anti-avoidance rules introduced in the ITA which are proposed to be made effective from the coming financial year or later.

COURSES

IBFD International Tax Academy

The International Tax Academy (ITA) combines the expertise and resources of IBFD with the knowledge of a global network of tax specialists. Now you too can benefit from this acknowledged source of expertise by signing up to one or more of our courses.

Forthcoming Courses in Asia

Tax Treaty Workshop

14-15 March 2013 | Location: Kuala Lumpur

Transfer Pricing: Intangibles and Intra-Group Finance

1-3 April 2013 | Location: Kuala Lumpur

Tax Risk Management

29-30 April 2013 | Location: Singapore

Practical Aspects of International Tax Planning

27-31 May 2013 | Location: Kuala Lumpur



Why choose ITA?

- Courses taught in English by leading experts.
- Further learning through additional online resources.
- Courses qualify for CPE credits.
- ITA is the foremost provider of training in international taxation.

Further information

Detailed information for all the courses can be obtained at www.ibfd.org.

For further information email itakl@ibfd.org or telephone +603-2287 0709.

IBFD, Your Portal to Cross-Border Tax Expertise

APITA/A30/198*125