

Basic Concepts – Royalty and Fees for Technical Services



14 June 2014
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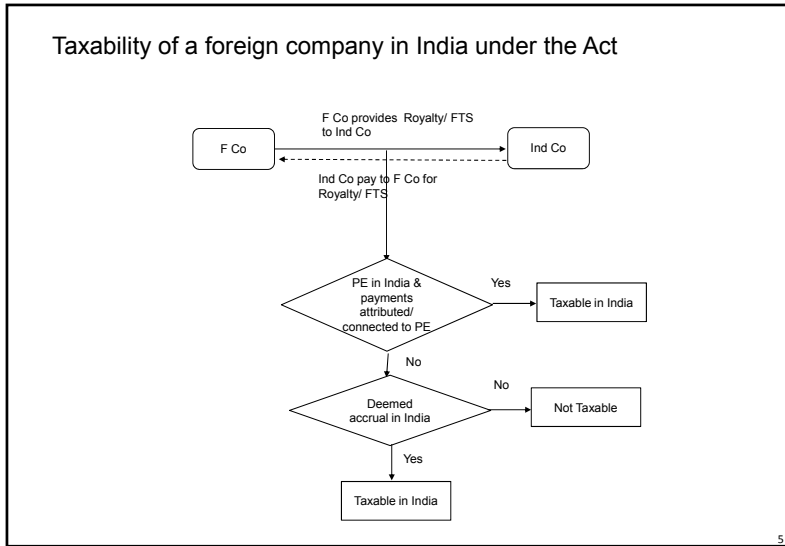
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Background - Taxability Rules

Taxability under the Act

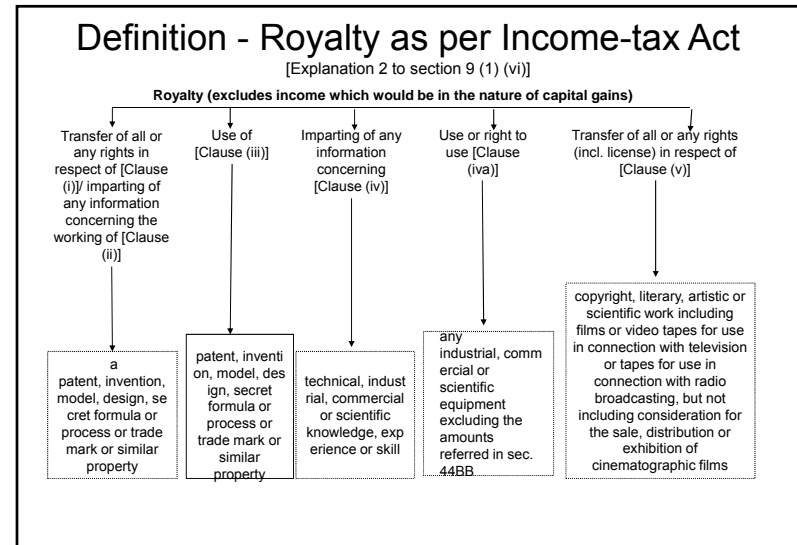
- Scope of taxable income of a foreign company – section 5(2)
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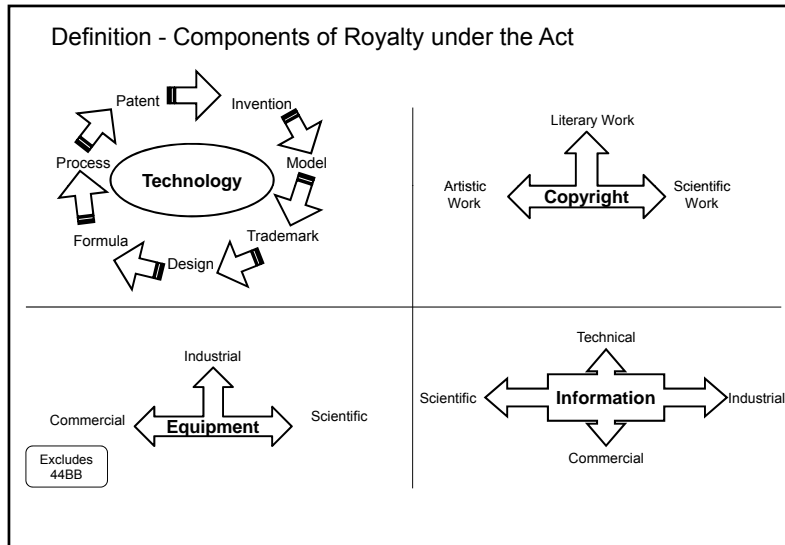
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Royalty

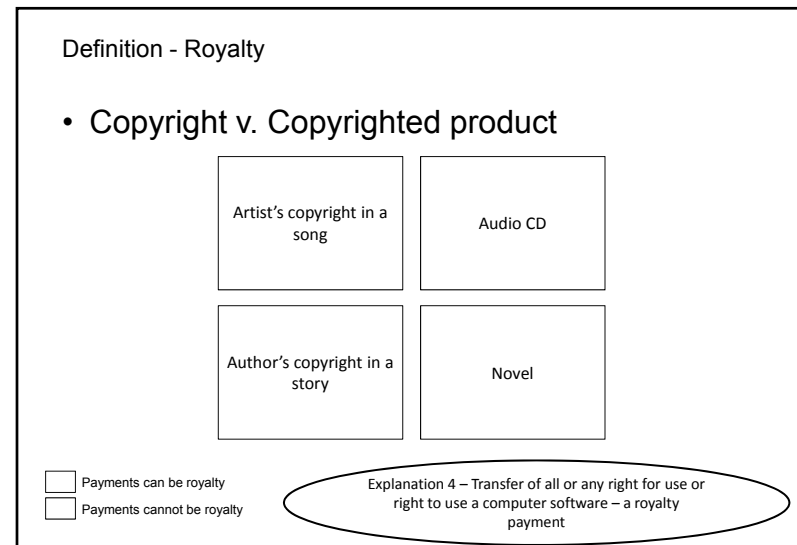
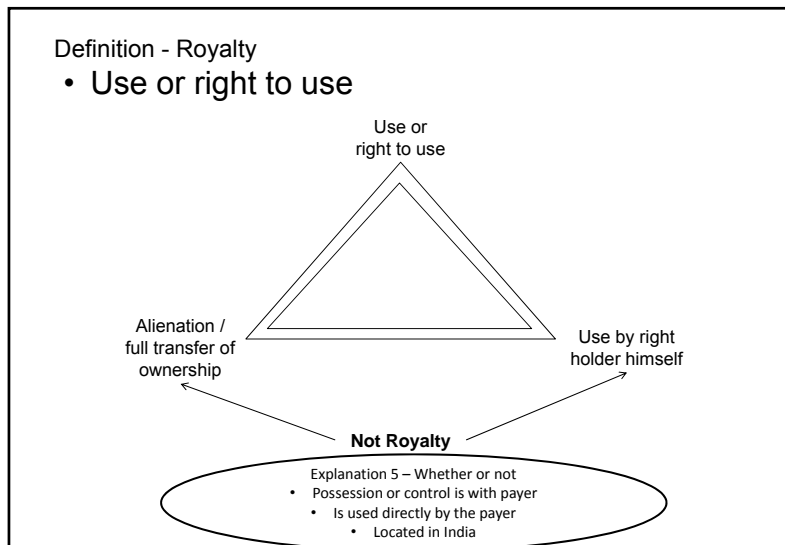
Royalty – Definition under the Act





Definition - What is not Royalty?

- Sale, distribution or exhibition of cinematographic films.
- Capital Gains on sale of IPR (patent, invention, model, design, secret formula, etc.)



Deeming rule

- Section 9(1)(vi)/(vii) of the Act deem royalty/FTS to accrue or arise in India where it is:
 - **Payable by the Government**
 - **Payable by resident unless** it is payable in respect of any right, property or information used or services **utilized**:
 - for the purpose of or in the **business or profession carried on by such resident outside India** or
 - for the purpose of **making or earning any income** from any **source outside India**
 - **Payable by non-resident** only if it is payable in respect of any right, property or information used or services **utilized**:
 - for the purpose of or in the **business or profession carried on by such non-resident in India** or
 - for the purposes of **making or earning any income** from any **source in India**

Amendments by the Finance Act 2012

Amendment by Finance Act, 2012

Explanation 4 to section 9(1)(vi)

For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

As per Memorandum to Finance Bill

Some judicial decisions have interpreted this definition in a manner which has raised doubts as to whether consideration for use of computer software is royalty or not ... **Considering the conflicting decisions of various courts in respect of income in the nature of royalty and to restate the legislative intent, it is further proposed to amend the Income-tax Act...**

India in its comment on the UN MC 2011 has recommended **“the use or right to use computer software, irrespective of the medium through which such right is transferred is to be construed as royalty”**

Retrospective amendment w.e.f.
1 June 1976

Amendment by Finance Act, 2012

Explanation 5: *For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—*

- (a) the possession or control of such right, property or information is with the payer;*
- (b) such right, property or information is used directly by the payer;*
- (c) the location of such right, property or information is in India.*

Explanation 6: *For the removal of doubts, it is hereby clarified that the expression “process” includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret*

Royalty – Definition under the model conventions

Royalty – Definition under model conventions

OECD Model	UN Model	US Model
<ul style="list-style-type: none"> • payments of any kind received • as a consideration • for the use of, or the right to use <ul style="list-style-type: none"> – any copyright of literary, artistic or scientific work – including cinematograph films – any patent, trademark, design or model, plan, secret formula or process – for information concerning industrial, commercial or scientific experience <ul style="list-style-type: none"> • Article 12.2 	<ul style="list-style-type: none"> • payments of any kind received • as a consideration • for the use of, or the right to use <ul style="list-style-type: none"> – any copyright of literary, artistic or scientific work – including cinematograph films, or films or tapes used for radio or television broadcasting – any patent, trademark, design or model, plan, secret formula or process – for the use of, or the right to use, industrial, commercial or scientific equipment – for information concerning industrial, commercial or scientific experience <ul style="list-style-type: none"> • Article 12.3 	<ul style="list-style-type: none"> • payments of any kind received • as a consideration • For the use of, or right to use: <ul style="list-style-type: none"> – copy right of literary, artistic or scientific or other work (including, computer software, cinematograph films, audio or video tapes or disks, and other means of image or sound reproduction) – any patent, trademark, design or model, plan, secret formula or other like property – Information concerning industrial, commercial or scientific experience

Differences in the Various Definitions

OECD Model	Income from equipment leasing would fall under rules for taxation of business profits – Article 5 and Article 7
UN Model	Consideration for use of, or the right to use, industrial, commercial or scientific equipment covered within the meaning of Royalties
US Model	Specifically includes consideration for use or the right to use copyright of computer software
Income tax Act	Specifically excludes consideration for sale, distribution and exhibition of cinematographic films

Definition - Royalty

- Use of industrial, commercial or scientific equipment

OECD Model	<ul style="list-style-type: none"> • Omitted from the OECD Model • Leasing income from use of industrial, commercial or scientific equipment would be characterized as “Business Profits” under Article 7
UN Model	<ul style="list-style-type: none"> • Retained under UN Model • Leasing income from use of industrial, commercial or scientific equipment characterized as “Royalty”
Indian DTAA's	<ul style="list-style-type: none"> • This term appears in most of the Indian tax treaties • Exceptions: Sweden, Israel and Greece • Most Favored Nation: Belgium, France, Kazakhstan, Netherlands and Spain

India's positions on OECD model

India's positions on OECD model (1)

- Reserves the right to characterize the following as royalties:
 - Right to use copyrighted article (as against right to use copyright)
 - Right to make multiple copies of computer programs for customer's own use
 - Transfer of rights for limited period or geographical area
 - Payment for distribution rights (in contrast to exploitation rights)

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India's positions on OECD model (2)

- Reserves the right to characterize the following as royalties:
 - Use or right to use ICS equipments
 - Development of a new design, model or plan
 - Distribution of computer programs
 - Transfer of full ownership or alienation of rights
 - Electronic downloading of digital products
 - Experience although not a previous experience

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Royalty – Definition under Tax Treaties

Brief Overview of Article 12 - Royalty

- 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’
- Article 12(4) – taxation of royalty if effectively connected with PE / fixed base of non-residents in the state of source
- Article 12(5) – Arising of royalty in the state of Source
 - Where payer is resident; and / or
 - If the payer has a PE / fixed base in the state of source and royalty is connected and borne by such PE / fixed base
- Article 12(6) – Adjustment for related party transactions
 - Excess over arm’s length price to be taxable as per domestic provisions

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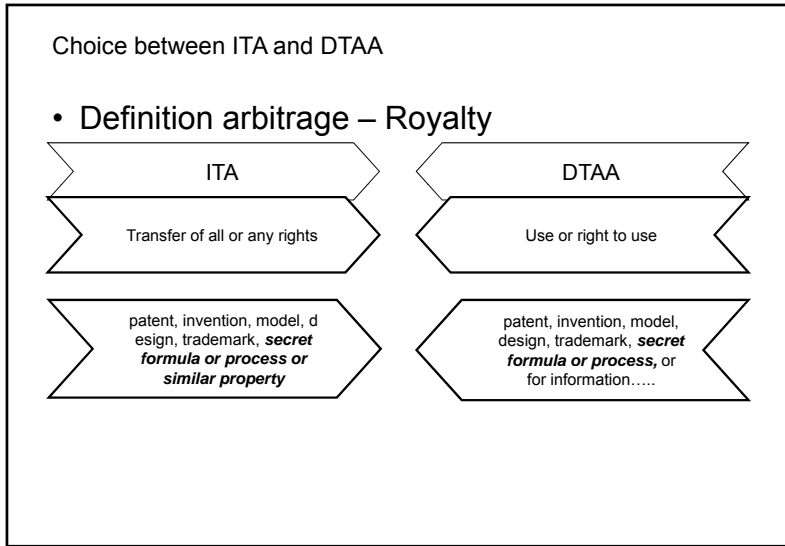
An overview of selected India’s DTAA (Royalty)

US	Russia	Australia
(a) the use of, or the right to use, any copyright or a literary, artistic, or scientific work including...any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition thereof ; and (b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment.....	(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including any patent, trade mark, design or model, plan, know-how, computer software programme , secret formula or process, or for information concerning industrial, commercial or scientific experience ; and (b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment.....	(a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade mark or other like property or right; (b) the use of, or the right to use, any industrial, commercial or scientific equipment; (c) the supply of scientific, technical, industrial or commercial knowledge or information; (d); (e) (f) (g) the rendering of any services which make available technical knowledge, experience, skill, know-how or processes or consist of the development and transfer of a technical plan or design..... (h); (i); (j); (k); or (l)

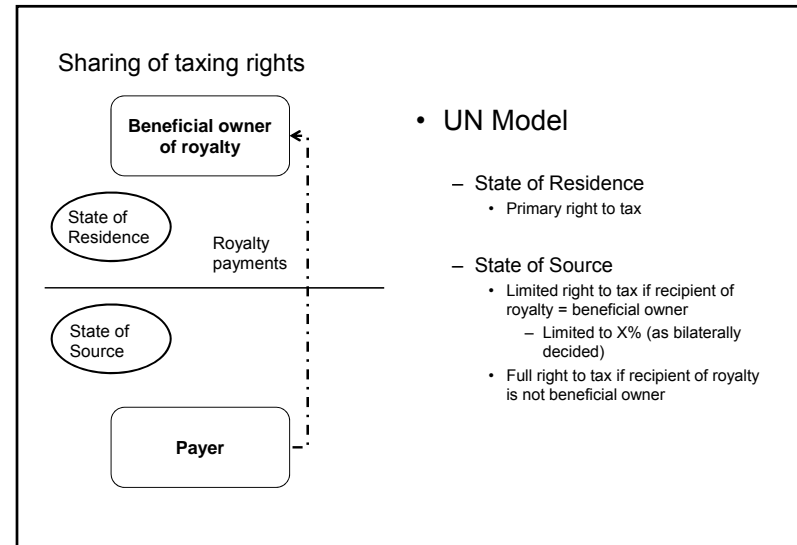
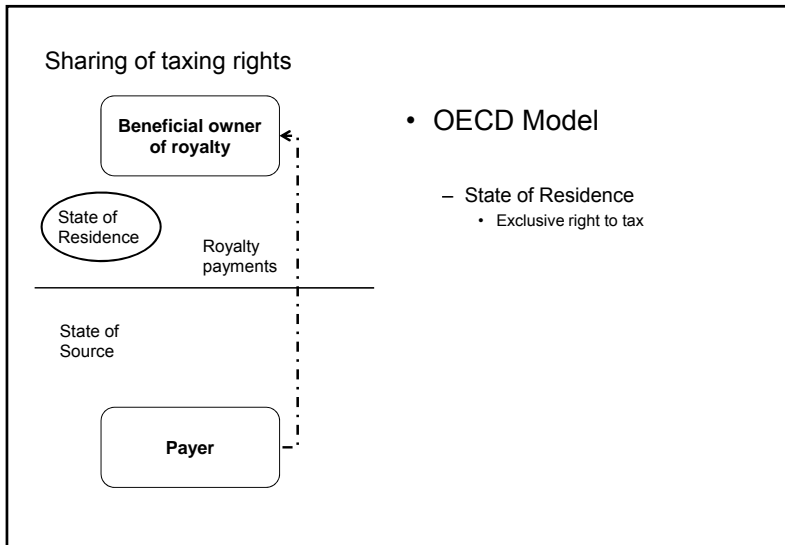
Definition of Royalty under certain Indian Treaties

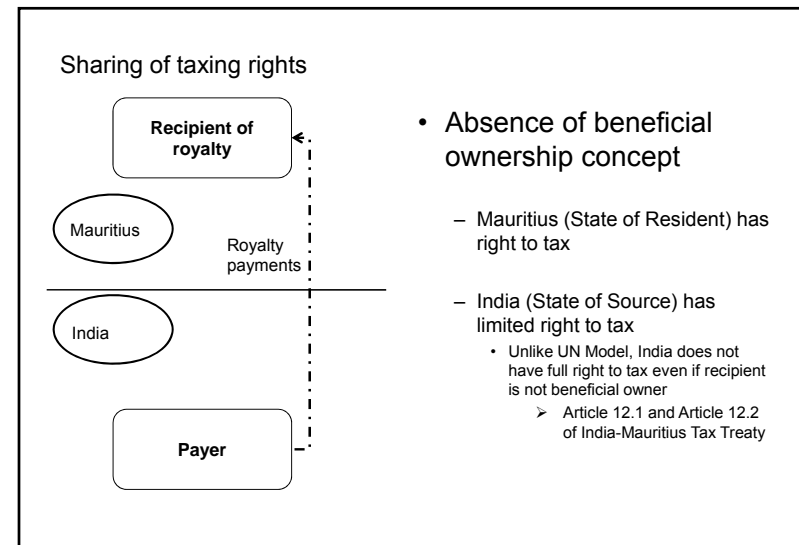
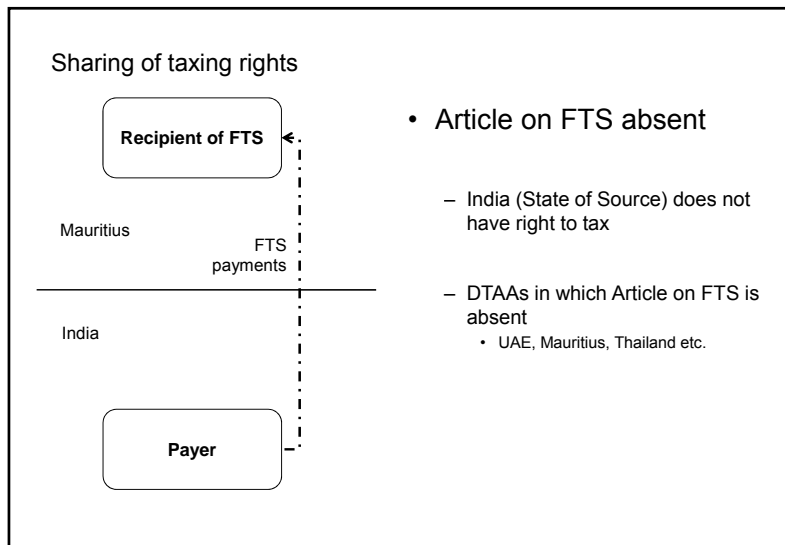
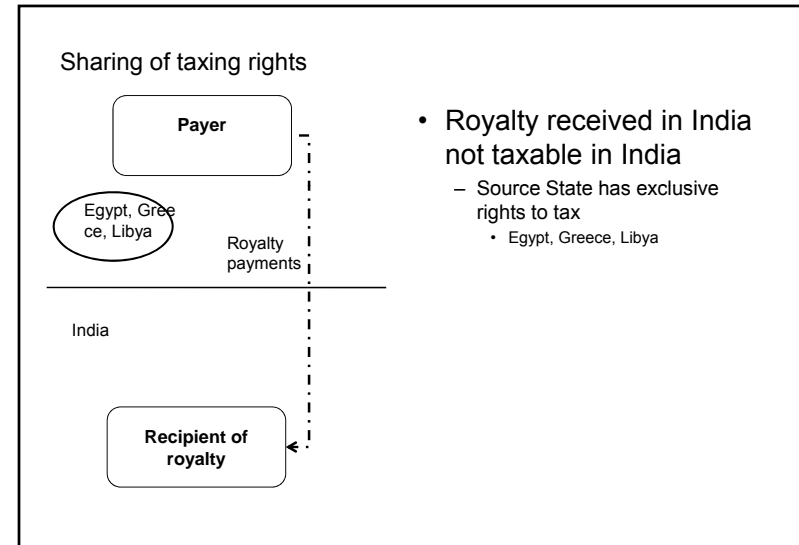
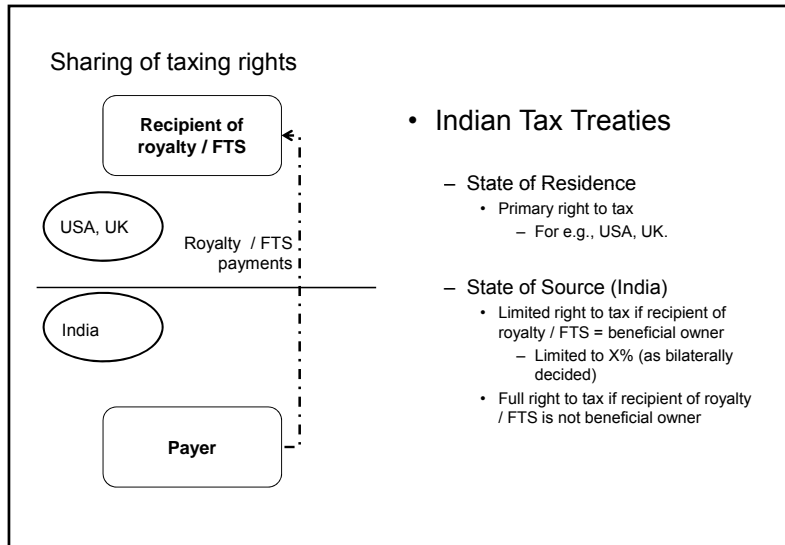
Country	Definition
Singapore	Includes gains from alienation of right, property or information
Morocco, Namibia, Russia and Kazakstan	Specific inclusion of software
Libya	Rental and other income from cinematograph films considered as business profits and not Royalties
Greece, Israel, Sweden, The Netherlands, Belgium	Does not include ‘Equipment Royalty’
Singapore, Thailand	Transfer of technology irrespective of nature of consideration
Canada, USA	Transfer of technology with contingent consideration

Royalty – Act v DTAA

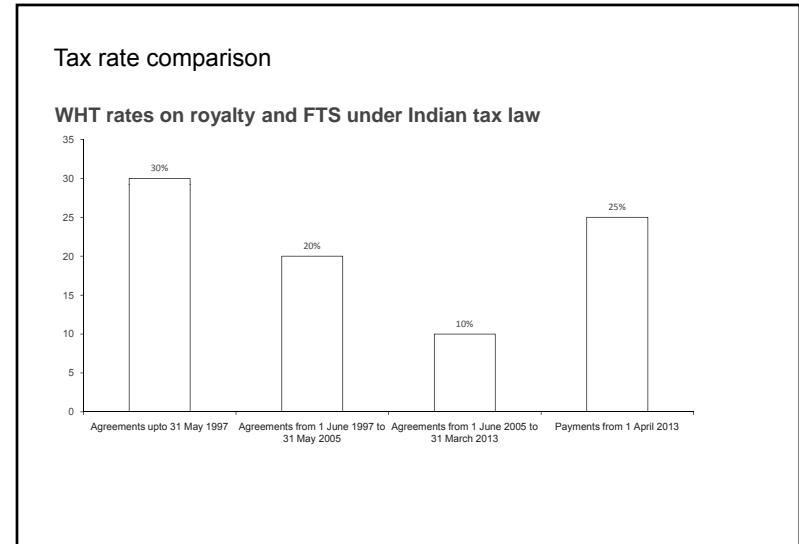


Royalty – sharing of taxing rights





Rates of Taxation



Tax rate under DTAA

Country	Year of enactment	Tax rate on royalty / FTS (%)
Australia	1992	10/15
Canada	1998	10/15
China	1995	10
France	1994	10
Germany	1996	10
Italy	1996	20
Japan	1990	10
Mauritius	1983	15
The Netherlands	1989	10
Singapore	1994	10
Spain	1995	10/20
United Kingdom	1994	15
USA	1990	15

Challenges

- Most of tax treaties between India and other countries specify the tax rate lower than 25%
- If the tax payer does not furnish **TRC** then the effective tax rate on Royalty / FTS would be 25%
- If the tax payer furnish TRC but does not furnish **PAN** then the effective tax rate on Royalty / FTS would be 20% (presuming treaty rate is not more than 20%)

Some Examples

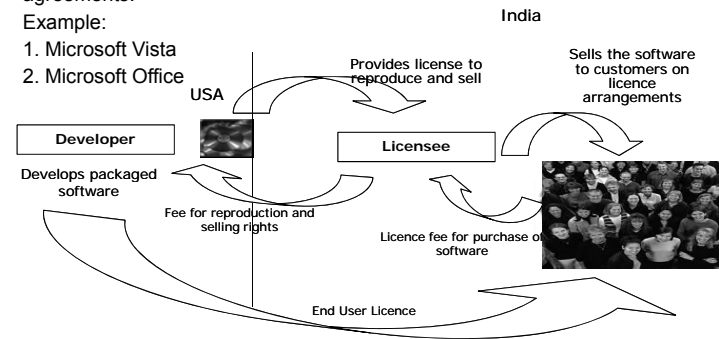
Software payments

Software - Shrink wrapped software

- Shrink wrapped software refers to off-the shelf or packaged software which are available to all the customers in same form without any customization. Software developers generally sell such software through licensing agreements.

Example:

- Microsoft Vista
- Microsoft Office

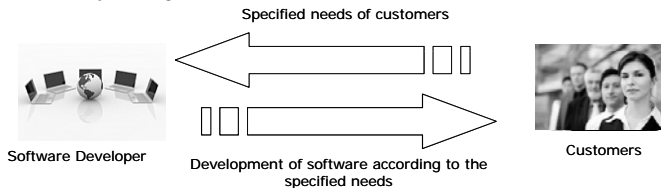


Software - Customized software

- Customized software refers to software which are developed/ customized according to the specified needs of a customer. Such software are developed for and in accordance to the specific needs of a particular customer and the same may not be useful to any other user. Generally the rights in the software lie with the customer.

Example:

- Specialized billing software for a company
- Inventory management software



Software - Customization Services

- Customization services refer to services wherein an off-the shelf software is modified and customized according the needs of the customer. In such a case, no new software is developed but an already marketable software is mapped according to the specified needs.

Example:

- Customization of ERP Software



Copyright Rights

- Copyright rights refers to the legal right to control the production and selling
- Per the Internal Revenue Service, USA, copyright rights refer to
 - the right to make copies for distribution to the public
 - the right to prepare derivative programs
 - the right to make a public performance of the program, and
 - the right to publicly display the program
- Copyright is a capital asset of intangible nature
- Grant of right to use of copyright for further production and/or selling amounts to royalty income
- Outright sale of copyright amounts to capital gains

Copyrighted Articles

- Copyrighted articles refer to the final products developed from the use of copyright
- Per the Internal Revenue Service, USA if a person acquires a copy of a computer program but does not acquire any of the copyright rights, the transfer is classified as a transfer of a copyrighted article
- It further provides that a copyrighted article is a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device
- Shrink wrapped software are generally copyrighted articles
- Income from sale of copyrighted articles is generally treated as business income

Software payments

Purchase of off-the-shelf software

```

    graph TD
      RH[Right holder (USA)] -- "Right holder licenses copyrights in the software" --> D[Distributor (Mauritius)]
      D -- "Distributor sells the software, e.g. MS Office, etc." --> U[User (India)]
      U -.->|Payments| D
      subgraph NotRoyalty [Not Royalty]
        U -.-> D
      end
  
```

- Distinction between licensing copyright and sale of copyrighted material
- Difference between sale of audio CD and the copyright to the songs in the audio CD
- Limited rights to user only to facilitate the use of program

Software payments

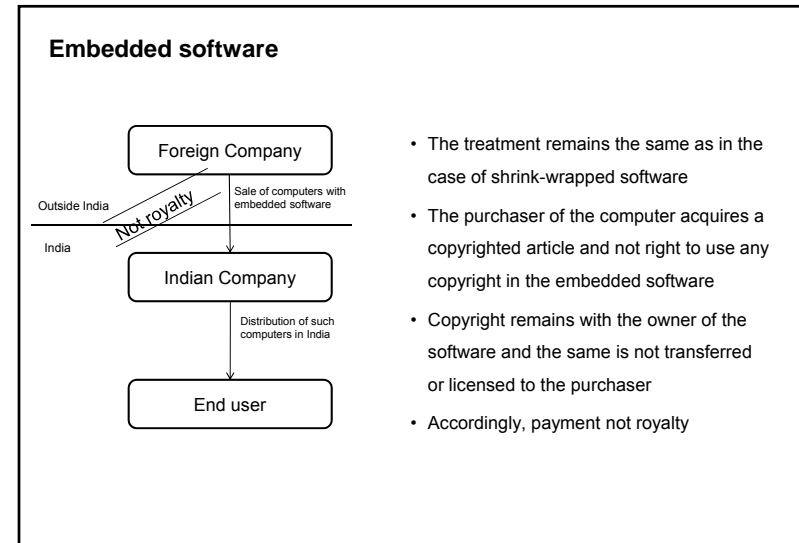
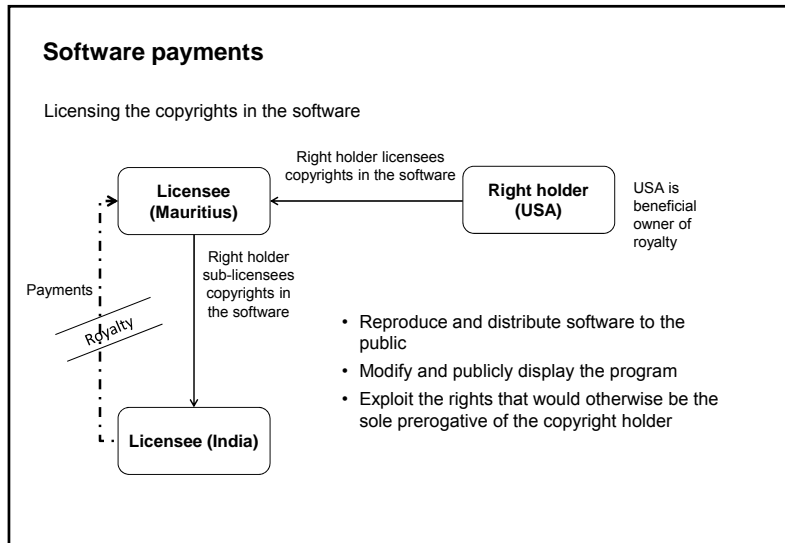
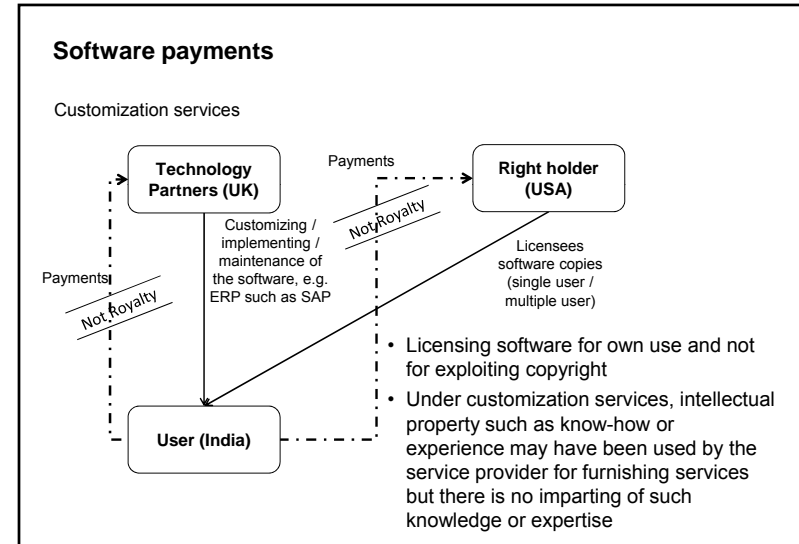
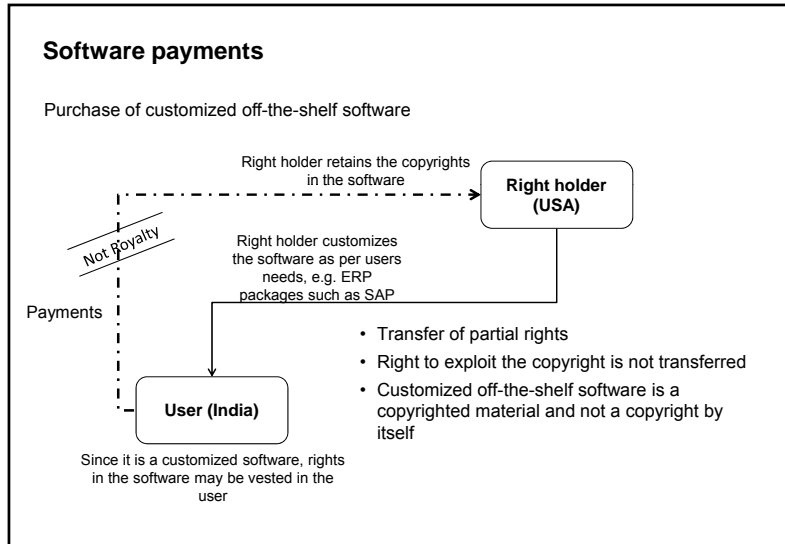
Purchase of custom made software

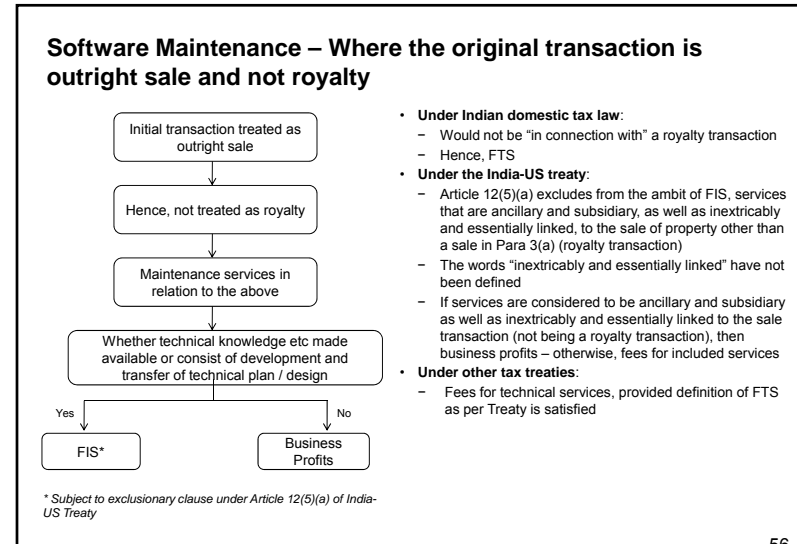
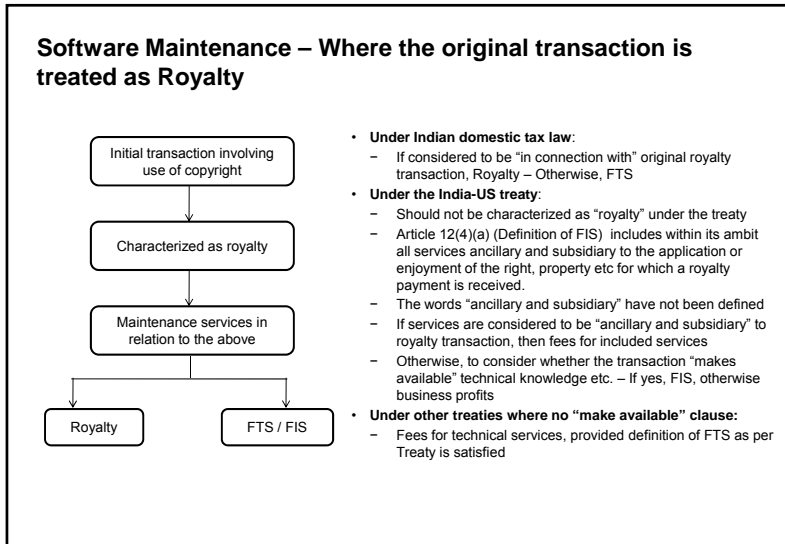
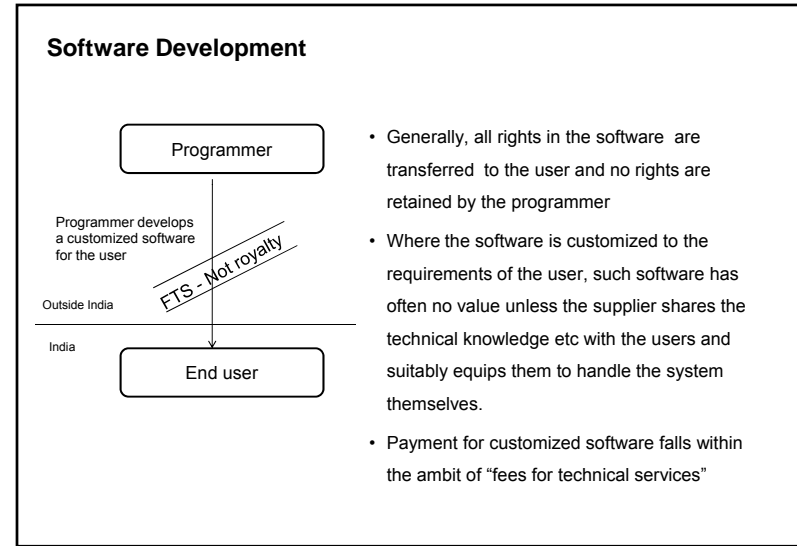
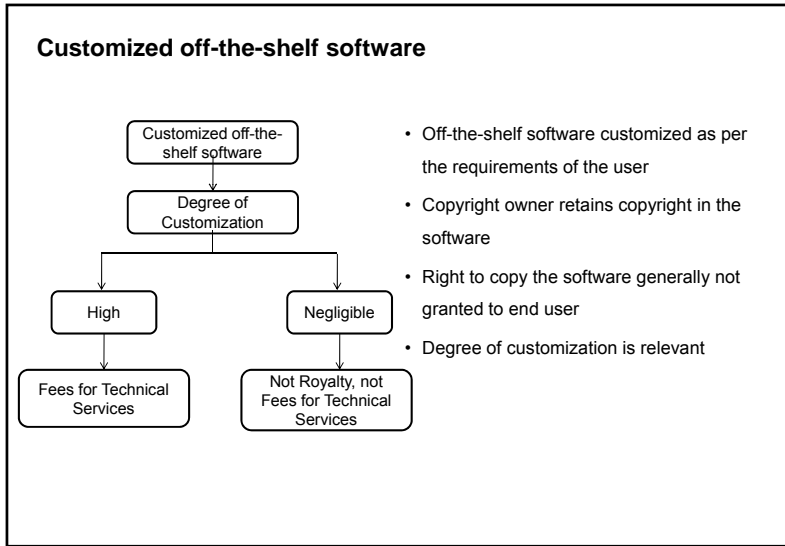
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    graph TD
      P[Programmer (UK)] -- "Programmer custom makes a software for the user" --> U[User (India)]
      U -.->|Payments| P
      subgraph NotRoyalty [Not Royalty]
        U -.-> P
      end
  
```

- Sale of copyrighted material
- User does not obtain the right to exploit the software in any way other than for his own needs

Since it is a customized software, rights in the software may be vested in the user





Implementation Services

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    graph TD
      subgraph Outside_India [Outside India]
        SP[Service provider]
      end
      subgraph India [India]
        EU[End user]
      end
      SP -- "Renders services with regard to software implementation" --> EU
      style SP stroke-dasharray: 5 5
      style EU stroke-dasharray: 5 5
      FTS["FTS / Royalty"]
  
```

- Treatment similar to maintenance services
- Original software transaction to be analyzed – whether royalty or outright sale
- Depending upon the classification of the original transaction, treatment as discussed in the preceding slides to apply

Royalty v. business income

- The High Powered Committee on 'Electronic Commerce and Taxation' constituted by CBDT in December 1999 expressed a view that software payments (whether for shrink-wrapped or customized) are consideration for the use of or the right to use any copyright of a 'scientific work', design or model plan, secret formula or process and therefore such transactions should be taxable as "royalty" on gross basis
- Indian revenue authorities have followed and continue to pursue the above position

Recent Decisions – Computer software

- In favour of assessee
 - DIT v. Infrasoftware Limited – (2013) – 220 Taxman 273 (Del.)
 - ❑ India-US DTAA – No royalty as the payments were not for transfer or use of any copyright in the software but were only for the use of a copyrighted material / article
 - Covergys Customer Management (2013) - (2013) – 220 Taxman 273 (Del.)
 - ❑ Same principle as held in Infrasoftware Ltd.
- Against the assessee
 - DDIT v. Reliance Infocom Ltd. – (2013) – 159 TITJ 589 (Mum.)
 - ❑ Payment made for license to use shrink wrapped / off the shelf software are in the nature of use of copyright and royalty under the Income-tax Act and under the India-USA DTAA

Significant Judicial Precedents

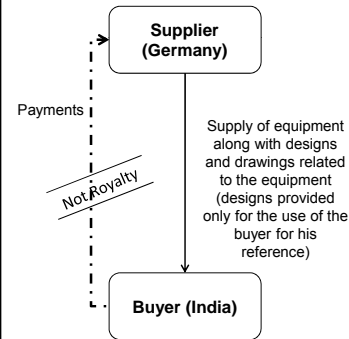
Whether payment for 'use' of software taxable as 'royalty' ?

In favor of assessee	Year of pronouncement	In favor of revenue	Year of pronouncement
Tata Consultancy Services [Supreme Court]	2004	IMT Labs India Private Limited [AAR]	2006
Sonata Software Limited [Bangalore Tribunal]	2005	Gracemac Corporation / Microsoft [Delhi Tribunal]	2010
Motorola Inc. [Delhi ITAT - Special Bench]	2005	ING Vysya Bank Limited [Mumbai Tribunal]	2011
Dassault Systems [AAR]	2010	Millennium IT Software Limited [AAR]	2011
GeoQuest systems BV [AAR]	2010	Samsung Electronics [Karnataka HC]	2011
Dynamic Vertical Software Ind. Pvt. Ltd. [Delhi HC]	2011	Lucent Technologies [Karnataka HC]	2011
Ericsson Radio System A.B [Delhi HC]	2011	Solid Works Corporation (Mum. Trib)	2013
Covergys Customer Management (2013) - 220 Taxman 273 (Del.)	2013	SKOL Breweries Ltd (Mum. Trib.)	2013
Infrasoftware Ltd. – 39 taxmann.com 88 (Del.)	2013	Reliance Infocom Ltd. –159 TITJ 589 (Mum.)	2013

Drawings & Designs – Case Studies

Designs and Drawings

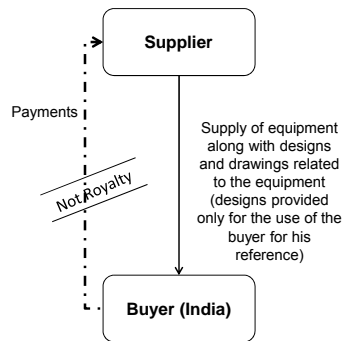
Supply of designs and drawings + equipment



- Generally, payments for use or right to use designs and drawings is "royalty"
- Whereas payments for outright transfer / sale of designs and drawings is not royalty
- Designs and drawings are incidental to the supply of equipment
- Such designs and drawings can be considered as a part of equipment supplied – capital cost

Designs and Drawings

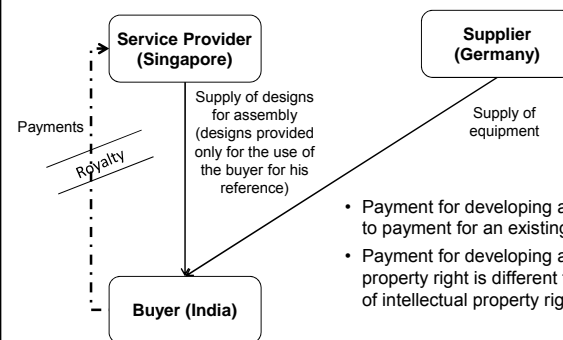
Supply of designs and drawings + equipment



- DIT v. Nisso Lwai Corporation – (2014) (AP HC)
- Davy Ashmore India Ltd. (190 ITR 626) (Cal)
- Swadeshi Polytex Ltd. (38 ITD 328) (Del)
- Modern Threads (India) Ltd. (243 ITR (AT) 60) (Jaipur)
- Klayman Porcelains Ltd. (229 ITR 735) (AP)
- Pro-quip Corporation (255 ITR 354) (AAR)
- Munak Galva Sheets (38 TTJ 569) (Del)
- Mitsui Engineering (259 ITR 248) (Del)
- Rotem Company (279 ITR 165) (AAR)
- Sundwiger EMFG (262 ITR 110) (AP)

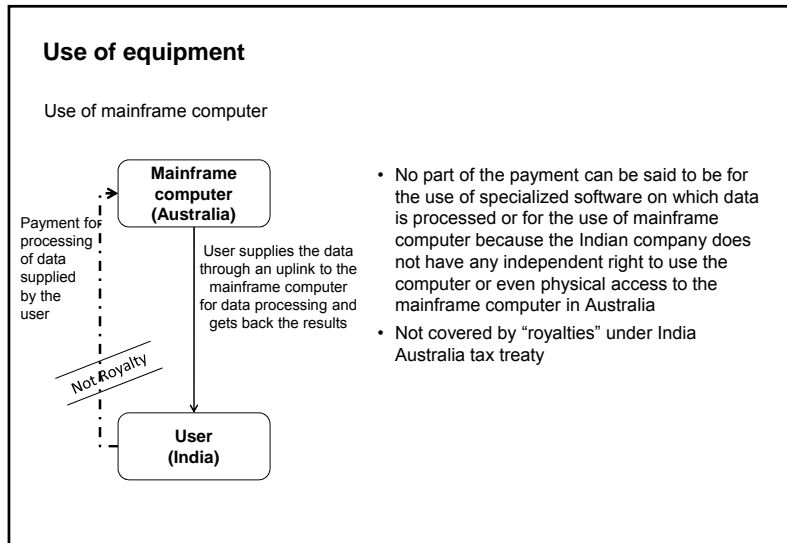
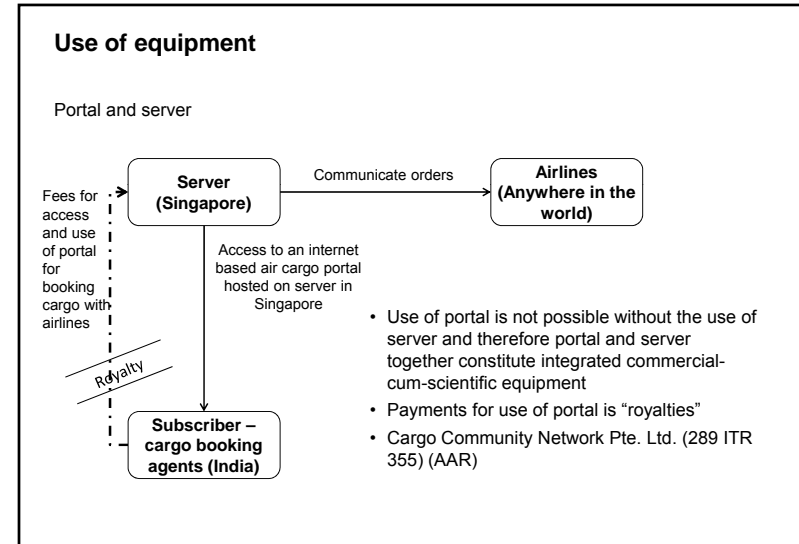
Designs and Drawings

Supply of designs (assembly project)

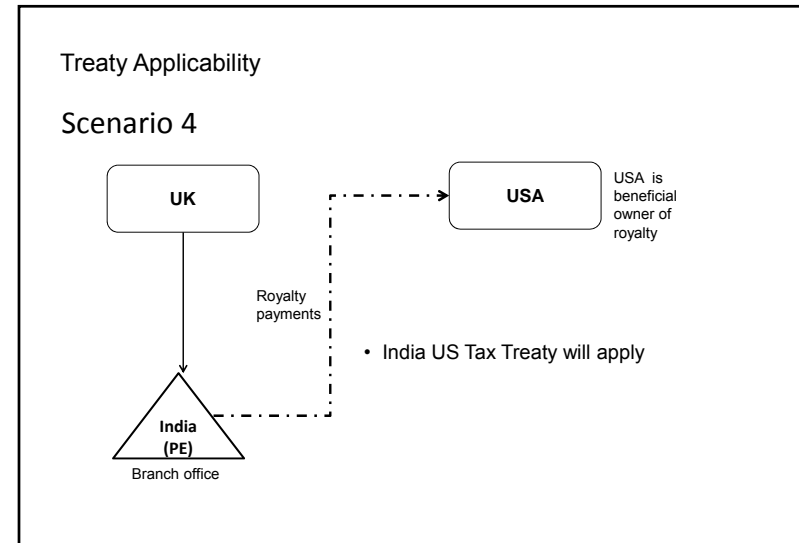
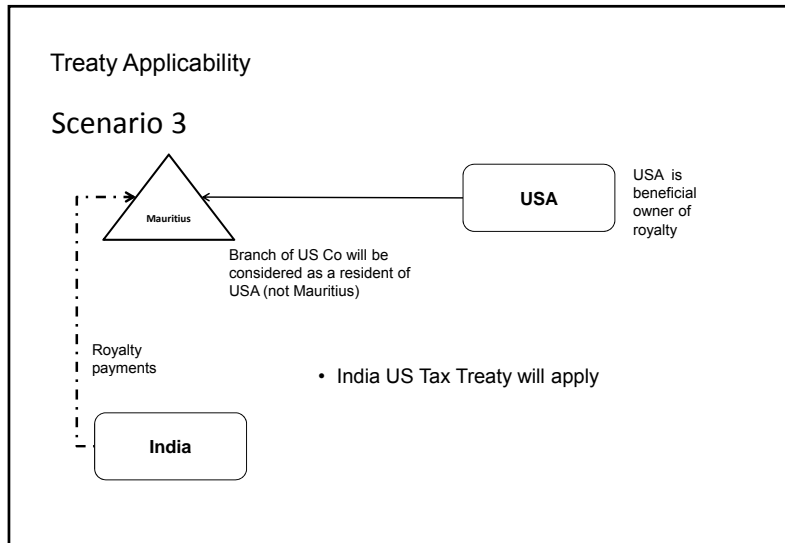
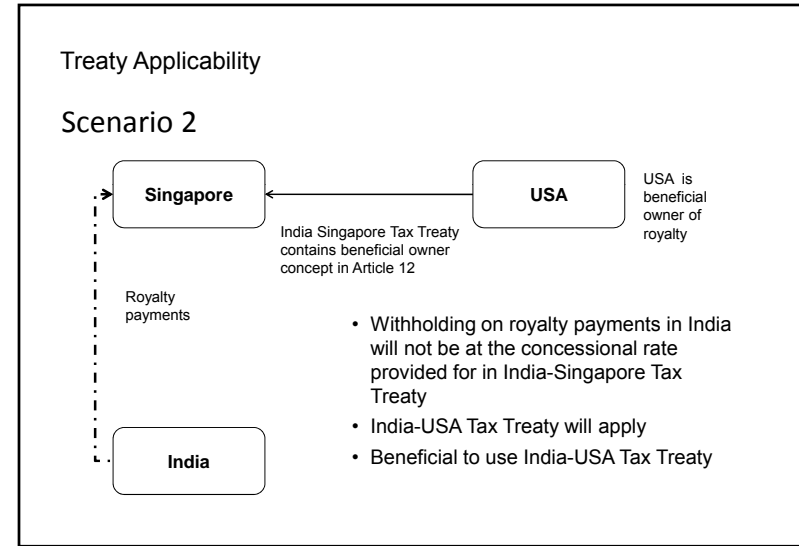
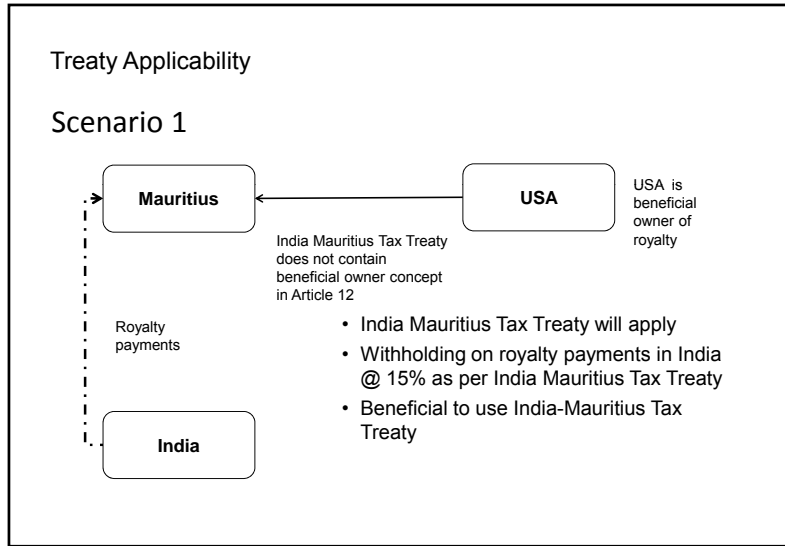


- Payment for developing a design as opposed to payment for an existing design
- Payment for developing an intellectual property right is different from paying for use of intellectual property right

Use of equipment – Case Studies



Treaty Applicability – Case Studies



Royalty - Some Issues

Royalty - some issues

- **Know-how with plant whether royalty**
 - Mitsui Engineering and Ship building Co. Ltd. 259 ITR 248 (Delhi)
 - Where it is not possible to apportion the consideration for design on one part and engineering, manufacturing, shop testing and packing up to FOB port on the other part, the transfer of design, if any is not royalty
 - Neyveli Lignite Corporation Limited 243 ITR 459 (Mad.)
 - Exclusivity of the right in relation to the thing for which royalty is paid should be with the grantor of that right. Supply of machine together with design is not a royalty
- **Information**
 - General information v. confidential information
 - ABC Limited 284 ITR 1 (AAR)
 - Payment for permission to download business information report is not a royalty or fees for technical services
 - HEG 263 ITR 230 (MP)
 - Payment for every information would not have the status of royalty

Royalty - some issues

- **Outright sale of know-how whether royalty?**
 - Payment for supply of capital asset v. use of capital asset
 - Scientific Engineering House Pvt. Ltd - 157 ITR 86 (SC)
- Income from time charter of ship from operations between Indian ports is taxable as royalty
 - Poompohar Shipping Corporation Ltd. v. ITO – 38 taxmann.com 150 (Mad.)

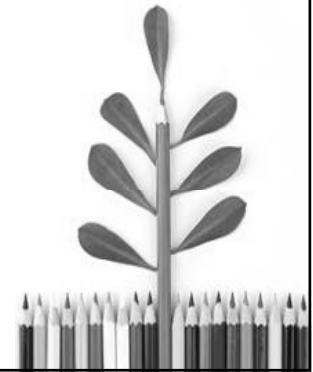
Royalty – some Issues

- **Annual Surveillance fees**
 - Hindalco Industries Limited 96 TTJ 1009 (Mum.)
 - Payment to credit rating agency for corporate credit rating is payment for professional services covered by Article 7 of the India-Australia Treaty and not a royalty
 - Essar Oil Limited 102 TTJ 270 (Mum.)
 - Credit rating certificate is commercial information and hence royalty as per Article 12 of the India-Australia Treaty
- **Provision of Marketing services outside India**
 - Marriott International Licensing Co. BV .v. DDIT(IT) (2014) 98 DTR 27 (Mum.)
 - Payment for providing marketing services outside India cannot be regarded as royalty. Further, royalty could always be a consideration paid only for use or right to use of any defined existing property and not for creation of defined property.

Fees for technical services

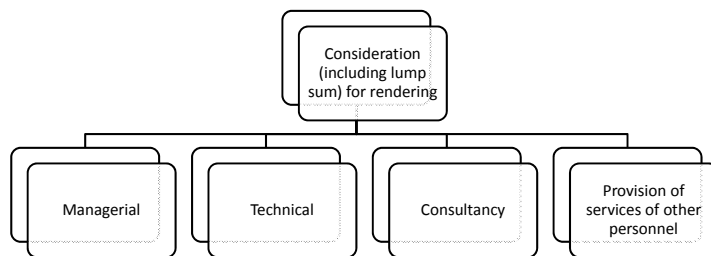


FTS - Definition



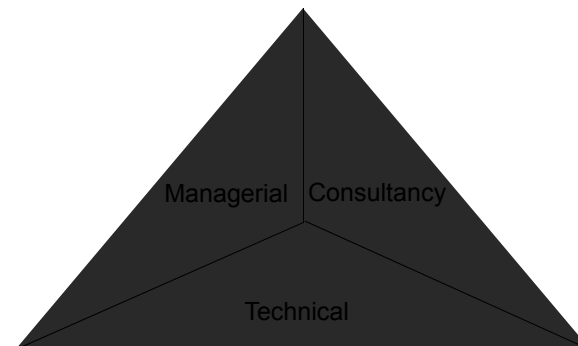
Fees for Technical Services – Definition

FTS defined in Explanation 2 to S.9(1)(vii) of Income-tax Act, 1961:



FTS does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries".

Components of fees for technical services under the Act...



History of amendments to FTS definition

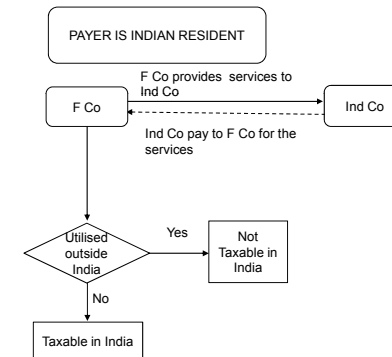
Amendments to the FTS definition under the Act

- Ishikawajma-Harima Heavy Industries (288 ITR 408) (SC) - territorial nexus necessary – services must be rendered in India

- Amendment to explanation to section 9(1)(vii) of the ITA (Finance Act 2007) (to overcome SC ruling) – with retrospective effect from 1-6-1976
 - For the removal of doubts, it is hereby declared that for the purposes of this section, where income is deemed to accrue or arise in India under clauses (v), (vi) and (vii) of ss. (1), such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India or the non-resident has rendered services in India.

- Jindal Thermal Power (321 ITR 31) (Kar) – Decision of SC still holds good after the Amendment

Deeming rules under the Act



*Utilised in a business or profession carried on in India or for the purpose of earning income from any source in India

FTS under Tax Treaties

FTS clause in most Indian tax treaties

FTS clause	FTS clause + Make available
<ul style="list-style-type: none"> • FTS means <ul style="list-style-type: none"> - payments of any amount in consideration - for the rendering of managerial, technical or consultancy services - including the provision of services of technical or other personnel - does not include payments for services mentioned in Independent / Dependent Personal Services 	<ul style="list-style-type: none"> • FTS means <ul style="list-style-type: none"> - payments of any amount in consideration - for the rendering of managerial, technical or consultancy services - including the provision of services of technical or other personnel - does not include payments for services mentioned in Independent / Dependent Personal Services - which make available technical knowledge, experience, skill know-how or processes - Excluding services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic

Key components of FTS under Tax Treaty

Managerial	Provision of services of technical or other personnel	Excludes payments for services mentioned in Independent / Dependent Personal Services
<ul style="list-style-type: none"> • Management functions • Management of affairs / people 	<ul style="list-style-type: none"> • Providing personnel to render technical services <ul style="list-style-type: none"> - For instance, engineers, technicians, consultants, etc. to furnish services for a fee • May cover deputation arrangements 	<ul style="list-style-type: none"> • Excludes payments which are covered by Article 14/15
Technical		
<ul style="list-style-type: none"> • Expertise in technology • Knowledge / skill related to technical field 		
Consultancy		
<ul style="list-style-type: none"> • Advisory services • Overlaps with technical services 		

An overview of selected India's DTAA (FTS)

US	Singapore	Netherlands	Russia
rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services are: (i)are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment ; or (ii)make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.	services of a managerial, technical or consultancy nature (including the provision of such services through technical or other personnel) if such services : (i)are ancillary and subsidiary,; or (ii)make available technical knowledge, experience, skill, know-how or processes,; or (iii)consist of the development and transfer of a technical plan or technical design, but excludes any service that does not enable the person acquiring the service to apply the technology contained therein	paymentsin consideration for services of a managerial, technical or consultancy nature, (including the provision of services of technical or other personnel) if such services (a).... (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	payments ...in consideration for the rendering of any managerial, technical or consultancy services including the provision of services by technical or other personnel <u>but does not include payments for services mentioned in Articles 14 and 15 ...</u>

Some beneficial tax treaties

Transactions	Treaty with India
No FTS Article	Bangladesh, Brazil, Greece, Libya, Mauritius, UAE
FTS restricted to transaction where technology is "make available"	Australia, Canada, Cyprus, Finland, Malta, Netherlands, Singapore, UK, USA
Managerial services not included	Canada, Spain, UK and USA

Make Available concept

- Fees for technical services**
- Make available clause – Examples
- Rendering of services by US Co such that I Co can use inventions, ideas and improvements obtained from US Co

 - Providing technical designs to enable I Co to perform mining job by themselves

 - Providing technical services and start-up services to enable promoters to set up power plant and run it on a going forward basis

 - Sending technicians to show personnel in I Co to undertake certain tasks

FTS - make available

Teach Fishing Rather than giving a Fish



Illustrative list of items for FTS


Make available technology	Does not make available technology
<ul style="list-style-type: none"> • Imparting technical training • Providing designs to enable the recipient to manufacture machinery • Providing process technology to enable the recipient to carry out processes on its own • Training and assistance in development of technology or processes • R&D activities 	<ul style="list-style-type: none"> • ISO certification • Review of designs and suggesting solutions • Computerised data processing • Medical diagnostic centres • Repair services • Market study reports • Services in connection with GDR issues

Fees for Included Services

Fees for included services (FIS)

- The concept of "Fees for included services (FIS)" included in Tax treaties entered into with USA, Canada, Cyprus, Malta, Netherlands, Portugal and Finland
- Payment of any kind to any person in consideration for the rendering of any technical or consultancy services only if such services make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or design
- Fees for included services do not cover "Consultancy services" unless those services are technical in nature

Choice between Act and DTAA



Choice between ITA and DTAA



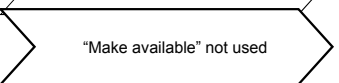
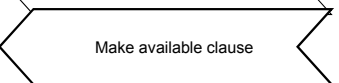
Opting for DTAA, if beneficial than ITA

Definition arbitrage Definition under the DTAA may be narrower than the definition under the ITA

Tax rate arbitrage Tax rates under the DTAA may be lower than the tax rates under the ITA



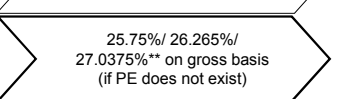
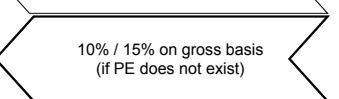
Choice between ITA and DTAA

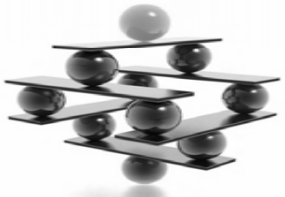
Definition arbitrage – FTS

 ITA	 DTAA
 "Make available" not used	 Make available clause

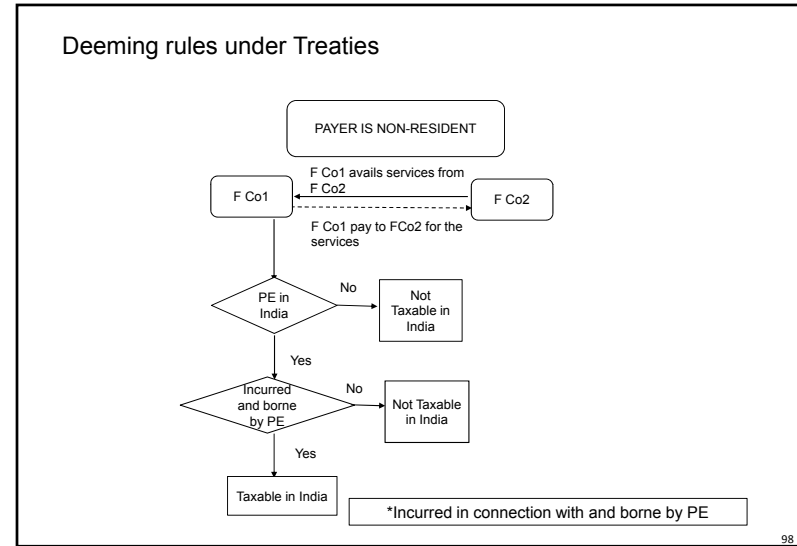
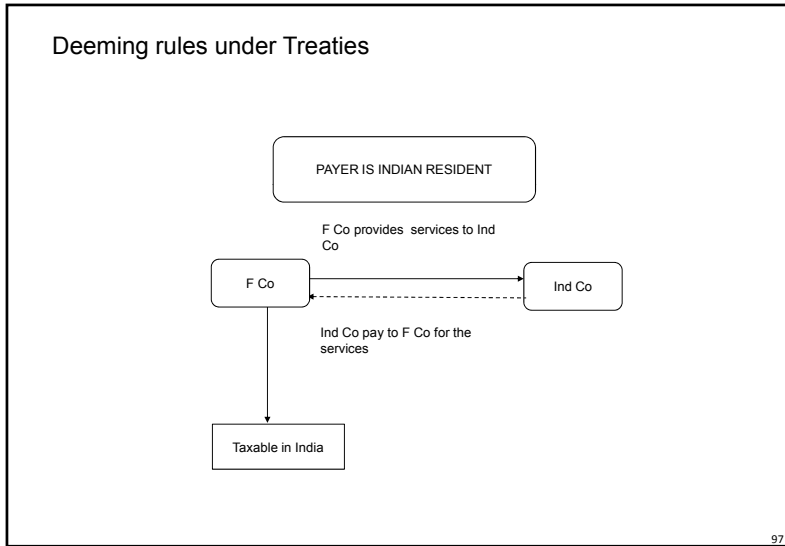
Choice between ITA and DTAA

Tax rates arbitrage

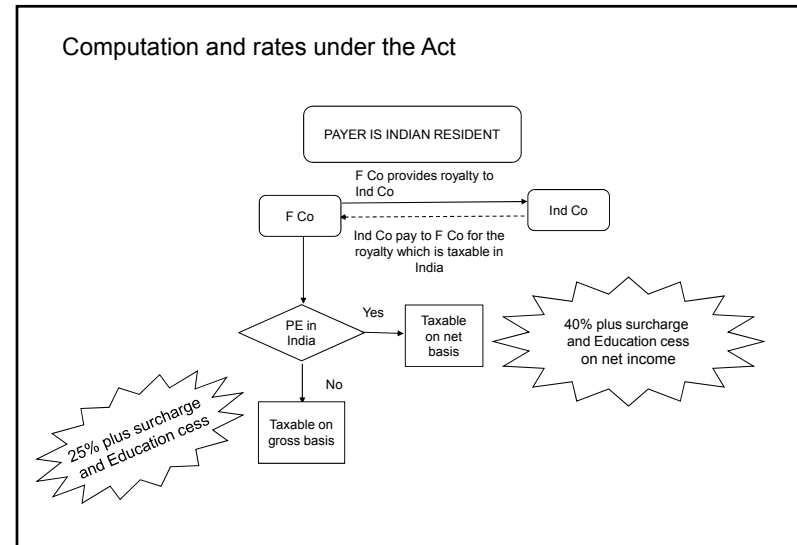
 ITA	 DTAA
 25.75%/ 26.265%/ 27.0375%** on gross basis (if PE does not exist)	 10% / 15% on gross basis (if PE does not exist)



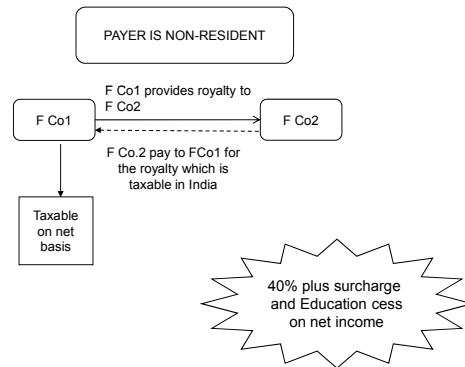
** The above tax rates are applicable to a corporate entity



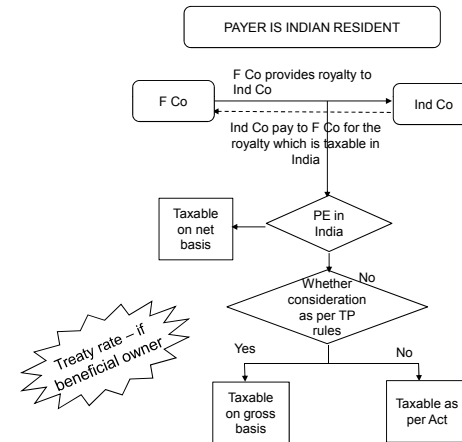
Computation rules and rates



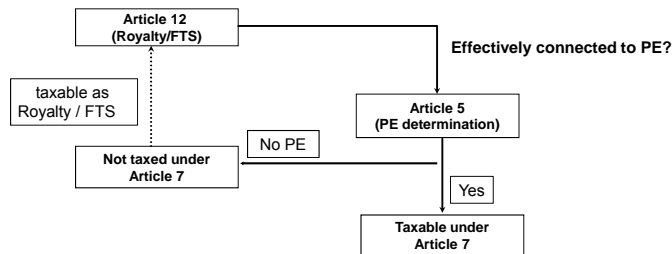
Computation and rates under the Act



Computation and rates under Treaties



Taxation of FTS when 'effectively connected' to PE



- India tax treaties carves an exception. Where there exists a PE and contracts are effectively connected to such PE, then receipts taxable under Article 7 and not under Article 12

FTS v. Independent Personal Services

- Scope of Article on Independent Personal Services
 - Generally applies only to individuals / firms
 - IPS taxable only in the state of Residence unless there is fixed base in the state of Source or physical presence exceeding specified threshold
 - Nature of independent activities covered
 - Scientific, literary, artistic, educational and teaching
 - Physicians, lawyers, engineers, architects, dentists and accountants
 - Article on FTS may specifically exclude items covered under IPS (e.g. Japan / New Zealand)
 - Even otherwise, if applicable, the Article on IPS should prevail over Article on FTS
 - IPS being a more specific Article within the service category
 - Tax position is generally more beneficial under IPS Article

Most Favored Nation Clause

- Most Favored Nation Clause
 - More favorable DTAA terms granted to other countries extended to existing treaty countries by Source country
 - ✓ Could be lower tax rate or narrowing the scope of income liable to tax
 - Generally, MFN status is contained in the protocol / exchange of notes
 - MFN clause is generally only prospective
 - Application is automatically or by negotiation and then notification
- Examples of key Indian tax treaties with MFN status in the context of Royalty / FTS
 - India-Netherlands DTAA
 - India-Belgium DTAA
 - India-France DTAA
 - India-Sweden DTAA

Case Studies

FTS – Explored Case Study - 1

Case Study 1

- X Ltd. was in the business of providing mobile telephone services to subscribers

Issue

- Whether consideration paid by subscribers constitute FTS under section 9(1)(vii) of the Act

Observations [Skycell – Madras High Court]

- Every provider of a facility cannot be regarded as providing technical services even though the facility is result of scientific and technological development and involves use of technology
- Installation and operation of sophisticated equipments with a view to earn income by allowing customers to avail of the benefit of the use of such equipment does not result in provision of technical service
- Payment is not for receiving technical service but for the facility to use the phone and get connected to others

Skycell – Madras High Court - 251 ITR 53

FTS – Explored Case Study - 2

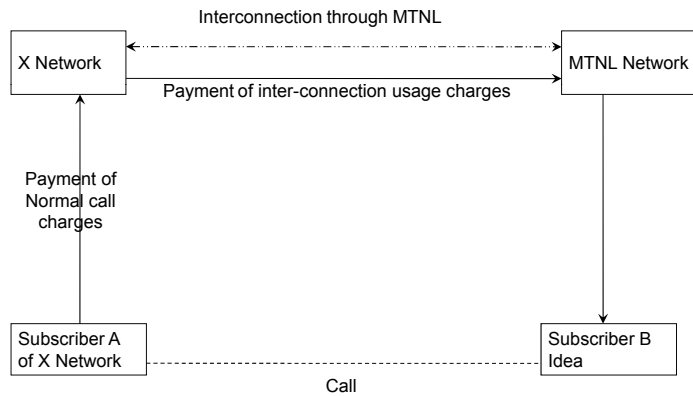
Case Study 2

- X Ltd., an Indian company is engaged in the business of providing cellular telephone facilities to their subscribers
- Interconnection service between the two networks is provided by MTNL or BSNL at interconnection points
 - Charges are paid for allowing a call to be carried from one service provider to another service provider
- Any operator who seeks interconnection from MTNL or BSNL needs to pay a interconnect/ port access charges

Issue

- Whether consideration paid constitute FTS

FTS – Explored Case Study - 2



FTS – Explored Case Study - 2

Observations [Bharti Cellular (SC)]

- Interconnect / port charges in question could not be regarded as FTS
- Both the words 'managerial' and 'consultancy' as appearing in the FTS definition involves a human element
 - Applying the rule of noscitur a sociis, the word 'technical' as appearing in FTS definition would also have to be construed as involving a human element
 - Facility provided by MTNL/ BSNL is provided automatically through machines
- The SC referred the matter back to the Assessing Officer for adjudication by taking into account an expert's opinion on whether any human intervention is actually involved in such transactions

Bharti Cellular (SC) 330 ITR 239

FTS – Explored Case Study - 3

Case Study 3Facts

- Raymond Ltd., engaged in the manufacture of suitings, engineers' steel files and rasps and cement in India proposed to issue Global Depositary Receipts (GDRs) in the international market
- Engaged Merrill Lynch International Ltd., a company incorporated in United Kingdom, as "lead manager"

Issue

- Whether payments to Merrill Lynch were chargeable to tax in India as "fees for technical services"

FTS – Explored Case Study - 3

Decision – Make available Interpretation [Raymonds – Mumbai Tribunal]

- Mere rendering of services is not make available unless the person utilizing the services is able to make use of the technical knowledge, etc. by himself in his business or for his own benefit without recourse to the performer of the services in future
- The technical knowledge, experience, skill, etc. must remain with the person utilizing the services even after the rendering of the services has come to an end
- Transmission of the technical knowledge, experience, skills, etc. from the person rendering the services to the person utilising the same is contemplated
- Some sort of durability or permanency of the result of the "rendering of services" is envisaged which will remain at the disposal of the person utilising the services

Raymonds – Mumbai tribunal [2003] 86 ITD 791

FTS – Explored Case Study - 4
<p>Facts</p> <ul style="list-style-type: none"> X Ltd. is a company incorporated in Singapore and is a diamond testing institute which was engaged in the grading of diamonds The Gemological Institute of America (GIA) was in business of grading and issuing certificate stating properties of diamonds X Ltd. was appointed as an agent by GIA. X Ltd. collected grading fee from customers in India and sought nil deduction of tax on the remittances that were to be made to GIA <p>Issue</p> <ul style="list-style-type: none"> Whether such grading could constitute FTS

FTS – Explored Case Study – 4 Contd.
<p>Decision</p> <ul style="list-style-type: none"> Undoubtedly the institute was using its experience in grading the diamonds but such grading could not be said to have transferred its experience, knowledge or skill to the customer, therefore, the transactions cannot be labelled as fee for technical services Payment of consideration would be regarded as 'fee for technical/ included services' only if the twin test of rendering services and making technical knowledge is available at the same time
<p>Diamond Services International – Bombay High Court [2008] 304 ITR 201</p>

FTS – Explored Case Study - 5
<p>Facts</p> <ul style="list-style-type: none"> Canadian company was engaged by the Indian Company to undertake technical services for upgradation of NHAI which includes technical drawings, detailed designs and reports <p>Issue</p> <ul style="list-style-type: none"> Whether the payments constitute "fees for included services" within the meaning of Article 12 of the DTAA with Canada or FTS as per section 9(1)(vii) of the Act for determination of rate of tax i.e. 15% or 20% <p>Decision</p> <ul style="list-style-type: none"> ITAT held that when the payment is for development and transfer of a technical plan or technical design, it need not be coupled with the condition that it should also make available technical knowledge, experience, skill, know-how, or process etc Condition of making available technical knowledge is not sine qua non for considering the question as to whether the amount is fees for included services or not particularly when the payment is only where the technical or consultancy services consists of development and transfer of a technical plan or technical design only. Accordingly, the payment was held to be in the nature of fees for included services as per Article 12(2) of the DTAA
<p>SNC-Lavalin International Inc. – ITAT Delhi - 26 SOT 155</p>

FTS – Explored Case Study - 6
<pre> graph TD EMEIA[EMEIA UK] -- "Providing support services in various fields" --> EY[EY India] EY -- "Payment of consideration" --> EMEIA </pre>
<p>Facts</p> <ul style="list-style-type: none"> EY India entered into Area Services and Market Development agreement with EMEIA, England (another EY Group company) for support services in various fields – strategy, Accounts and business development, marketing, internal communication, legal, finance etc. Services were rendered from UK and were provided for achieving standardization of human, financial and other resources <p>Issue</p> <p>Whether the payment by EY India to EMEIA for support services is 'fee for technical services' under India UK DTAA</p>

<p>FTS – Explored Case Study – 6 (contd.)</p>	
<p>Decision</p> <ul style="list-style-type: none"> • These services do not make available technical knowledge possessed by EMEIA: <ul style="list-style-type: none"> – Services rendered only provide information on business and commercial matters , guidelines, best practices etc. Some of the services are only managerial services which are not covered in DTAA – EMEIA has not developed any technology. No transfer of any technical knowhow from EMEIA. – Recipient of centralized service have not been able to apply any technology possessed by EMEIA • Payments not in the nature of fee for technical services under India UK DTAA. 	
<p>Ernst and Young (P) Ltd – (AAR) - 323 ITR 184</p>	

<p>FTS – Explored Case Study - 7</p>	
<pre> graph TD AM[AM] -- "Payment for rendering bauxite testing services" --> CAIECL[CAIECL] subgraph China CAIECL end subgraph India AM end </pre>	<p>Facts</p> <ul style="list-style-type: none"> • AM entered into an agreement with CAIECL, China under which CAIECL was to render bauxite testing services. The services were to be performed by CAIECL in its labs in China. The test reports were also to be prepared in China <p>Issue</p> <ul style="list-style-type: none"> • Whether the payment for these services could be regarded as 'fee for technical services' under India China DTAA <p>Extract of DTAA – The term " fees for technical services" as used in this Article means any payment for the provision of services of managerial, technical or consultancy nature by a resident of a Contracting State <u>in the other Contracting State</u>, but</p>

<p>FTS – Explored Case Study – 7 (contd.)</p>	
<p>Decision</p> <ul style="list-style-type: none"> • These payment for the testing services were fee for technical services and taxable in India even though the services were rendered in China <ul style="list-style-type: none"> – As per the retrospective amendment to section 9 by the Finance Act, 2010 utilisation of services in India was enough to warrant taxability even though the services were rendered outside India. – The scope of term 'provision for services' used in Article 12(4) of the India China DTAA is wider than 'provision for rendering of services'. It will cover the services not rendered in India as long as they are utilised in India. – Article 12(6) of the India China DTAA provided that FTS will be deemed to arise in the state in which the payer is located irrespective of the place in where the services are rendered • Payments were in the nature of fee for technical services under India China DTAA and the Act. 	
<p>Ashapura Minichem – (Mum.) - 40 SOT 220</p>	

<p>FTS – Explored Case Study - 8</p>	
<p>Facts</p> <ul style="list-style-type: none"> • 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 • The US contractors work with the technicians in the Indian firm for few months <p>Analysis</p> <ul style="list-style-type: none"> • The services of the personnel of the US Co fulfill both the requirements of Article 12(4) of US Treaty <ul style="list-style-type: none"> – The services are technical or consultancy in nature; – They make available to the Indian company technical knowledge; skill, and processes. • Payments will be regarded as FIS 	
<p>Example No.3 Indo/US MoU</p>	

FTS – Explored Case Study - 9

Facts

In the previous example, consider that

- The US Co has a wallboard fabrication plant outside India and the Indian Co hires the US Co to produce wallboards at that plant for a fee
- The Indian Co provides the raw material and the US Co uses its advance technology to manufacture the wallboard at its plant

Analysis

- Though the US Co is performing a technical service.....no technical knowledge, skill, etc. are made available to Indian Co;
- There is no development or transfer of a technical plan or design
- US Co merely performs contract manufacturing service, hence payment not to be regarded as FIS

Example No.4 Indo/US MoU



Thank you



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