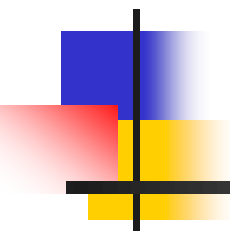


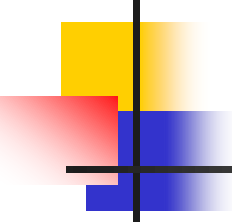
CERTIFICATE COURSE ON INTERNATIONAL TAXATION BY WIRC OF ICAI



Fees for Technical Services (FTS) & Royalty

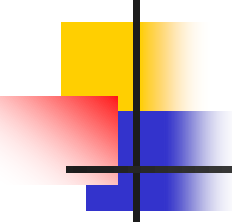
Presented by:
Mr. Paresh P. Shah

P.P. Shah & Associates
Chartered Accountants
Email: ppshahandassociates@gmail.com



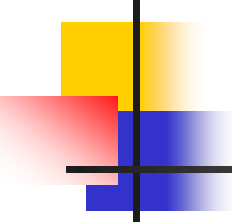
Overview of Presentation

- Taxation of Non-Residents on Royalty & Fees for Technical Services ('FTS') – A rationale
- Meaning of FTS and Royalty
- Definition under UN, OECD and US Models
- Source Rule
- Fees for Technical Services – Meaning
- Treaty and Tax Laws (ITA)
- Fees for Included Services
- Independent personnel services
- Services through Permanent Establishment
- Survey of India's Tax Treaty



FTS – A Rationale

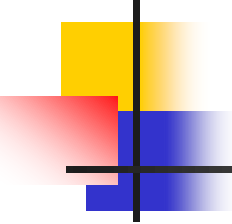
- Non-resident develops skill and knowledge in their country of residence
- Expenditure claimed in taxation of Resident Enterprise in possession of technical knowledge
- Resident taxation under OECD Model for Royalty and absence of Article on FTS
- Gross basis of taxation at concessional rate in Source State



Definitions: Royalty & FTS

- Payments of any kind received as a consideration for the use of, or the right to use 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, or for the use of, **or the right to use, industrial, commercial or scientific equipment** or for information concerning industrial, commercial or scientific experience

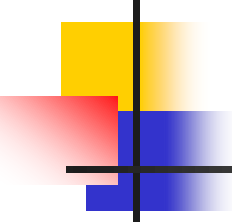
[OECD Model, OECD plus **UN Model**]



Definitions: Royalty & FTS

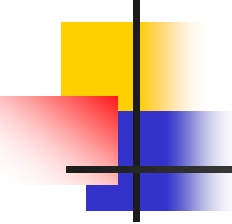
- As per Article 12(2) royalty means:
 - a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; and
 - b) gain derived from the alienation of any property described in subparagraph a), to the extent that such gain is contingent on the productivity, use, or disposition of the property

[US Model]



Definitions: Royalty & FTS (con't)

- IT Act, 1961: Consideration for
 - (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention or similar property ;
 - (ii) the imparting of any information on working of ;
 - (iii) the use of any patent, invention, ;
 - (iv) the imparting of any information or skill ;



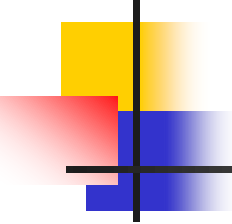
Definitions: Royalty & FTS (con't)

- IT Act, 1961: Consideration for

(iva) the use or right to use equipment but not including the amounts referred to in section 44BB;

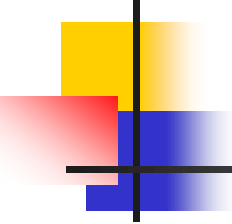
(v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, , but not including cinematographic films ; or

vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v)



Definition: Fees for Technical Services

- No separate Article under either UN Model or OECD Model
- FTS defined under the Act any consideration (including any lump sum 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 under the head “Salaries”
[Explanation 2 to Section 9(1)(vii)]
- Priority rule of Section 9(1)
 - General provision vs specific



Definition: Fees for Technical Services (con't)

9(1): The following incomes shall be deemed to accrue or arise in India :—

(i) all income accruing or arising, whether directly or indirectly.....situate in India

(ii)

..

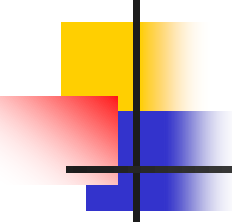
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Definition: Fees for Technical Services (con't)

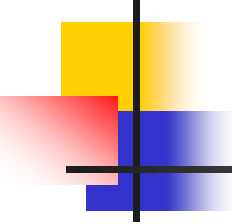
(vii) income by way of fees for technical services payable by—

(a) the Government ; or

(b) a person who is a resident, except where the fees are payable in respect of services utilised in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or

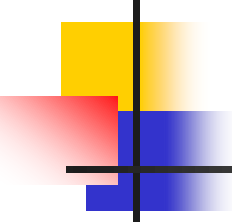
(c) a person who is a non-resident, where the fees are payable in respect of services utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India

- Proviso: It is in respect of FTS paid pursuant to agreement made before 1.4.1976, to which section does not apply



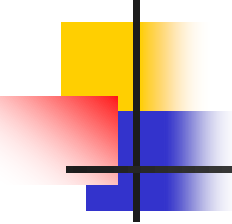
Definition: Fees for Technical Services (con't)

- Explanation 1: It is in respect of FTS paid pursuant to agreement made after 1.4.1976 and states that agreement is deemed to have been made before 1.4.1976 if the agreement is in accordance with the proposals approved by the Central Government before that date
- Explanation 2: It is about what constitutes 'technical services'



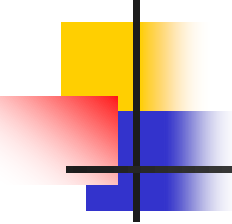
Source Rule & Scope - FTS

- Services are paid by specified persons, Government, Resident & Non-resident
- Services are in accordance with the proposals approved by the Government
- Services are used / utilised in India
- What about location of services to be rendered in India
 - Rendered in India and utilised in India
[Territorial nexus: Ishikawajima's case 288 ITR 408(SC)]
 - Retrospective clarificatory amendment w.e.f. 1.4.1976 through Finance Act, 2007 to Section 9
 - Deemed to accrue or arise in India and shall be included in the total income of the non-resident whether or not
 - (i) the non-resident has a residence or place of business or business connection in India or
 - (ii) the non-resident had rendered services in India



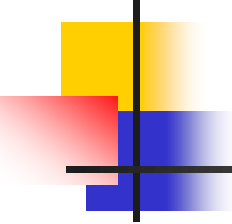
Source Rule & Treaty - FTS

- Royalties and FTS arising in a contracting state and paid to a resident of the other contracting state may be taxed in that other state [Article 12(1)]
- Royalties or fees for technical services shall be deemed to arise in a contracting state when the payer is a resident of that state. Where, however, the person paying the royalties, whether he is a resident of a contracting state or not, has in a contracting state a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the state in which the permanent establishment or fixed base is situated [Article 12(5)]
- Article 12(5) states only a source rule but no distribution rule as found in Article 12(1)



Meaning of FTS

- Managerial: conducting business, continuous service with human intervention or not. Whether administrative services included? [Intertek Testing Services India (P) Ltd. AAR No. 751 of 2007 dt. 7.11.2008]
- Technical: involving applied and industrial science [Refer Skycell's case, Oberoi Hotel's case and Boston Consulting's case]
- Consultancy services: services of advisory nature without the use of any tools and appliances, overlapping with technical services
- Services through PE: IPS under Article 15 and other services under Article 5 r.w. Article 7



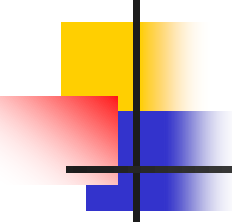
Meaning of FTS (con't)

- Technical services Vs Technology driven services
- Use of Technology for rendition of standard services
- Services as distinguished from Products
- Standard services vs development; anticipated demand vs commencement of work as specified
- Designs could be products or services depending upon its nature as to standard design vs specially developed / tailor-made to suit the need of the recipient
- Pre-dominant and essential characteristics of Service is important
- Services are also included in the definition of Royalty
- Possible overlap of Services with Royalty



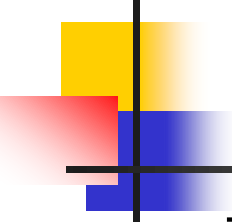
Technology based Services

Underlying service	Embedded IPR content	What does the recipient of service get?
Internet service provider	IRU of lit fibre	Internet user
Application service provider (E.g. B2B, B2C ordering)	Software	Business prospects
Online Games played on Gaming Portals	IPR in games being copyright	Amusement
IBFD online tax information	Knowledgeware	Education and information
Live telecast of music event	Copyright	Real time entertainment



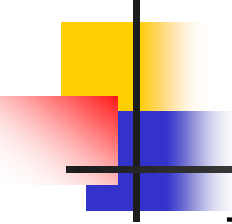
Meaning of FTS & DTAA

- Non-residents are taxable in India and have option to beneficial tax treatment as provided in section 90(2) of ITA
- OECD & UN Model does not contain FTS article
- Comparison between ITA & Treaty provisions
- India's Treaty and FTS article
 - Absence of FTS article
 - FTS included / overlapping with income in Article 15 on IPS
 - FTS included in Article 12 as FFIS
 - FTS as Article 13 of the Treaty (India-Malaysia) or Article 12 along with Royalty (Indo-Japan)
- FTS article covers source rule, distribution pattern, definition of FTS, Beneficial owner, deemed arising of FTS, FTS effectively connected to PE
- Typically provides for six paragraphs



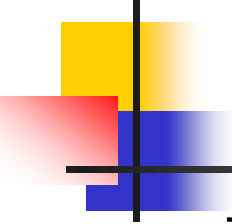
MODEL FTS IN INDIA'S TREATY

- **Indian – Malaysia Tax Treaty: Article 13 : FEES FOR TECHNICAL SERVICES –**
 1. Fees for technical services arising in a Contracting State which are derived by a resident of the other Contracting State may be taxed in that other State.
 2. However, fees for technical services may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the recipient is the beneficial owner of the fees for technical services, the tax so charged shall not exceed 10 per cent of the gross amount of the fees for technical services.
 3. The term “fees for technical services” means payment of any kind in consideration for the rendering of any managerial, technical or consultancy services including the provision of services by technical or other personnel but does not include payments for services mentioned in Article 14 and Article 15 of this Agreement.



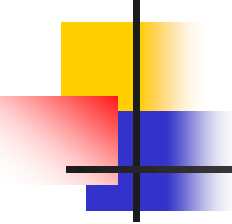
MODEL FTS IN INDIA'S TREATY

- **Indian – Malaysia Tax Treaty: Article 13 : FEES FOR TECHNICAL SERVICES (con't)–**
- 4. The provisions of paragraph 1 of this Article shall not apply if the beneficial owner of the fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the fees for technical services are effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.
- 5. Fees for technical services shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority or a statutory body thereof, or a resident of that State. Where, however, the person paying the fees for technical services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees for technical services was incurred, and such fees for technical services are borne by such permanent establishment or fixed base, then such fees for technical services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.



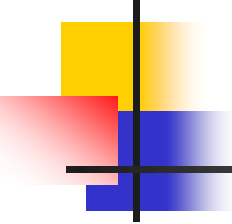
MODEL FTS IN INDIA'S TREATY

- Indian – Malaysia Tax Treaty: Article 13 : FEES FOR TECHNICAL SERVICES (con't)–
 6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the fees for technical services paid exceeds, for whatever reason, the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall only apply to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Agreement.



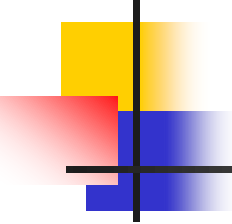
FTS & DTAA

- Restricted non-resident tax liability under treaty could be due to
 - Narrower scope due to treaty Source Rule
 - Lower tax rate
 - Narrower scope due to definition
 - Fees for Included Service / make available concept in Treaty
 - Presence of Most favoured nation Clause in the treaty by protocol or otherwise



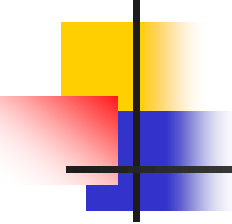
Absence of Article on FTS

- No distributive rules for Technical Services
- Income may be covered under Article 15
- If Article 15 is not applicable then it can be treated as business income
- If no PE in source state then such business income cannot be taxed in source state
- India's treaty with Mauritius, Philippines and Saudi Arabia does not have specific Article on FTS / Technical Services



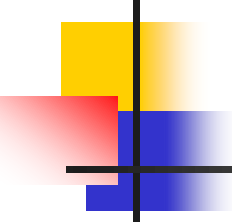
Scope of Income from Independent Personal Services

- OECD deleted the Article and merged it with Article 7 r.w. Article 5
- It covers Professional Services of independent character
- Individuals and Firms are covered
- Fixed base as condition for source state taxation
- Normally IPS and FTS / FFIS may also have concurrent presence
- Article on FTS provides for exclusion of IPS related activity in order to avoid overlap e.g. USA & UK



Scope of Income from Independent Personal Services

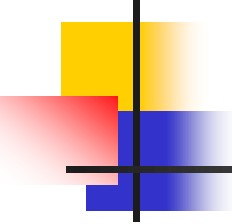
- Most Indian treaties provide for exclusion of IPS from FTS / FIS
- Payment is in nature of IPS then Article on FTS / FIS does not apply [86 ITD 384 (KC)]
- IPS broadly means services by Individuals
- Certain treaty uses the expression 'Services rendered by Residents of the contracting state' e.g. Cyprus, Mauritius, Netherlands indicating that it may cover companies resident in these states
- UK, USA, Canada, etc. uses the expression 'Individuals or the individuals as a member of the firm'



Fees for Included Services

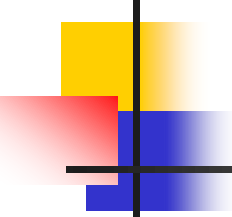
- Indo-US Tax treaty incorporates concept of Fees for Included Services and concept of 'make available'
- Definition of FIS: For the purposes of this article, 'Fees for included services' means payment of any kind to any person in consideration for rendering of any (i) technical or (ii) consultancy services (including through the provision of services of technical or other personnel) if such services:
 - a. are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in para 3 (i.e. royalty) is received; or
 - 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.

[Paragraph (4) of the India – USA Treaty]



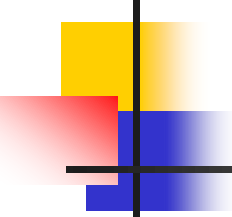
Fees for Included Services

- Source taxation is possible only if services could be technical or consultancy (managerial is absent). Should make available technical knowledge, etc. as provided
- Technical services under ITA may not qualify the above test inferring 'no' source taxation
- Make available refers that recipient service should be enabled to make use of technology / technical knowledge in future
- If does not satisfy conditions, then under treaty, income will be treated as business income taxable in source state only if there is a presence of PE in source state i.e. service PE



FIS - Meaning of “make available”

- “Included Services” defined narrowly to mean services which “make available” technical knowledge, experience, skill, know-how or processes or which consist of development and transfer of technical plan or technical design
- MoU of the India USA Tax Treaty:
 - Technology will be considered "made available" when the person acquiring the service is enabled to apply the technology
 - Provision of requiring technical input by the person providing the service does not per se mean that technical knowledge, skills, etc., are made available
 - Use of a product which embodies technology shall not per se be considered to make the technology available
- If the services do not “make available” technical knowledge, etc., then, they are outside the ambit of FIS Article and not taxable



FIS - Applicability of India US MoU to other tax treaties

- Tax treaties with Australia, Canada, Netherlands, Singapore, UK, etc. have FIS clause more restrictive or akin to India US Tax Treaty
- Other tax treaties do not include an MoU similar to the MoU to the India US Tax Treaty
- Emerging judicial consensus:
 - MoU represents the views expressed by the Government of India
 - To the extent provisions in other tax treaties are *pari materia* with the India US Tax Treaty, MoU can be followed to interpret other tax treaties

DCIT v. BCG 94 ITD 31 (Mum) – India/Singapore

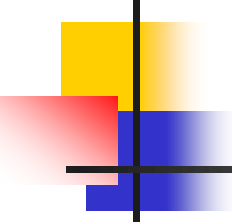
McKinsey & Co. v. ADIT 99 ITD 549 (Mum) – India/Singapore

BPCL v. Jt DIT 111 TTJ 375 (Mum) – India/Singapore

Raymond v. DCIT 80 TTJ 120 (Mum) – India/UK

CESC 87 ITD 653 (Kol)(TM)

ITO v. De Beers India Minerals Private Limited (ITA 3400, 3401 & 3402/Blr/04)(Blr) :
India/Netherlands



Fees for Included Services

- A Ltd. engaged in supply of technical personnel to B Ltd. in India
- B Ltd. is in need of technical personnel for its project in USA
- A Ltd. incorporates subsidiary in USA, employs required technical personnel and deutes it to project site of B Ltd. in USA
- A Ltd. signs agreement with B for certain deliverables including assurance as to technical qualification of deputed personnel
- A Ltd. Signs manpower supply agreement with its WOS

Discuss the payment by B to A Ltd. and A to its Subsidiary

FIS - Examples

- EXAMPLE (1) Facts:

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

- EXAMPLE (2) Facts:

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

- EXAMPLE (3) Facts:

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

- EXAMPLE (4) Facts:

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

- EXAMPLE (5) Facts:

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

- EXAMPLE (6) Facts:

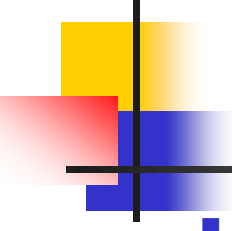
An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify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

- EXAMPLE (7) Facts:

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

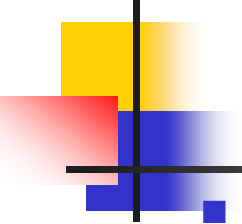
- EXAMPLE (8) Facts:

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



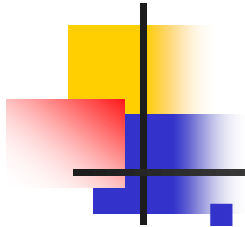
■ EXAMPLE (9) Facts:

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



■ EXAMPLE (10) Facts:

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

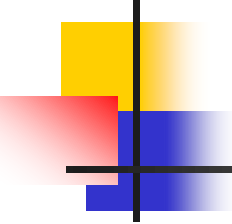


■ EXAMPLE (11) Facts:

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

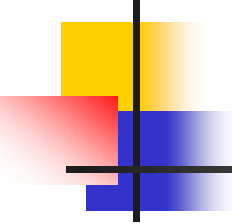
- EXAMPLE (12) Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installation. Are the fees paid to the American firm by the Indian individual fees for included services?



FEES FOR TECHNICAL SERVICES

- In this type of treaties, most of the treaty have definitions which is similar to that of ITA
- Some treaty do not cover Equipment Lease e.g. Greece, Netherlands, Norway, etc.
- Presence of MFN Clause restricts the scope of source taxation consequent upon 'New Treaty' signed by the source state e.g. Belgium, France, Hungary, Israel, Spain, Sweden and Switzerland



SERVICE PE

- If services are effectively connected to the fixed place / fixed base in source state
- Presence of technical or other personnel and minimum presence
- Services are rendered through PE or services are rendered by technical or other personnel in source state
- Recent OECD MC on Service PE



FTS: Some case studies

FACTS / ISSUES

RATIO

Technology based Services:

Consideration paid by subscribers to mobile telephone service provider whether FTS?

No as payment is for facility to avail of the benefit of use of equipment even though it is result of scientific and technological development [Skycell – Chennai High Court]

Interconnection service between networks provided by MTNL/BSNL to cellular company whether FTS?

No as both the words 'managerial' and 'consultancy' in FTS definition would have to be construed as involving a human element whereas the facility in question is provided automatically through machines [Bharti Cellular – Supreme Court]



FTS: Some case studies (con't)

FACTS / ISSUES	RATIO
Consideration paid for services to issue GDRs in the international market whether FTS?	No as mere rendering of services is not 'make available' unless the person utilising the services is able to make use of the technical knowledge by himself in his business without recourse to the performer of the services in future [Raymonds – Mumbai Tribunal]
Consideration paid for training of personnel for use of simulator with or without instructor whether FTS?	Yes; it satisfies the 'make available' test as simulators are highly sophisticated machines which cannot be operated unless requisite technical knowledge is given to user [Sahara – ITAT]



FTS: Some case studies (con't)

FACTS / ISSUES	RATIO
Consideration for grading of diamonds whether FTS?	No as it cannot be said to have transferred its experience, knowledge or skills to the customer. Also, payment can be regarded as 'fee for technical included services' only if the twin test of rendering services and making available technical knowledge at the same time is satisfied [Diamond Services Intl. – Mumbai High Court]
Consideration for advice and other services, designs, etc for installation of water features in assessee's premises whether 'fees for included services'?	Yes as even where the technical design or plan is transferred for purpose of mere use of such design or plan, Article 12 of India-USA DTAA is attracted as it does not contemplate transfer of all rights, title and interest [Gentex Merchants – ITAT Kolkata]



FTS: Some case studies (con't)

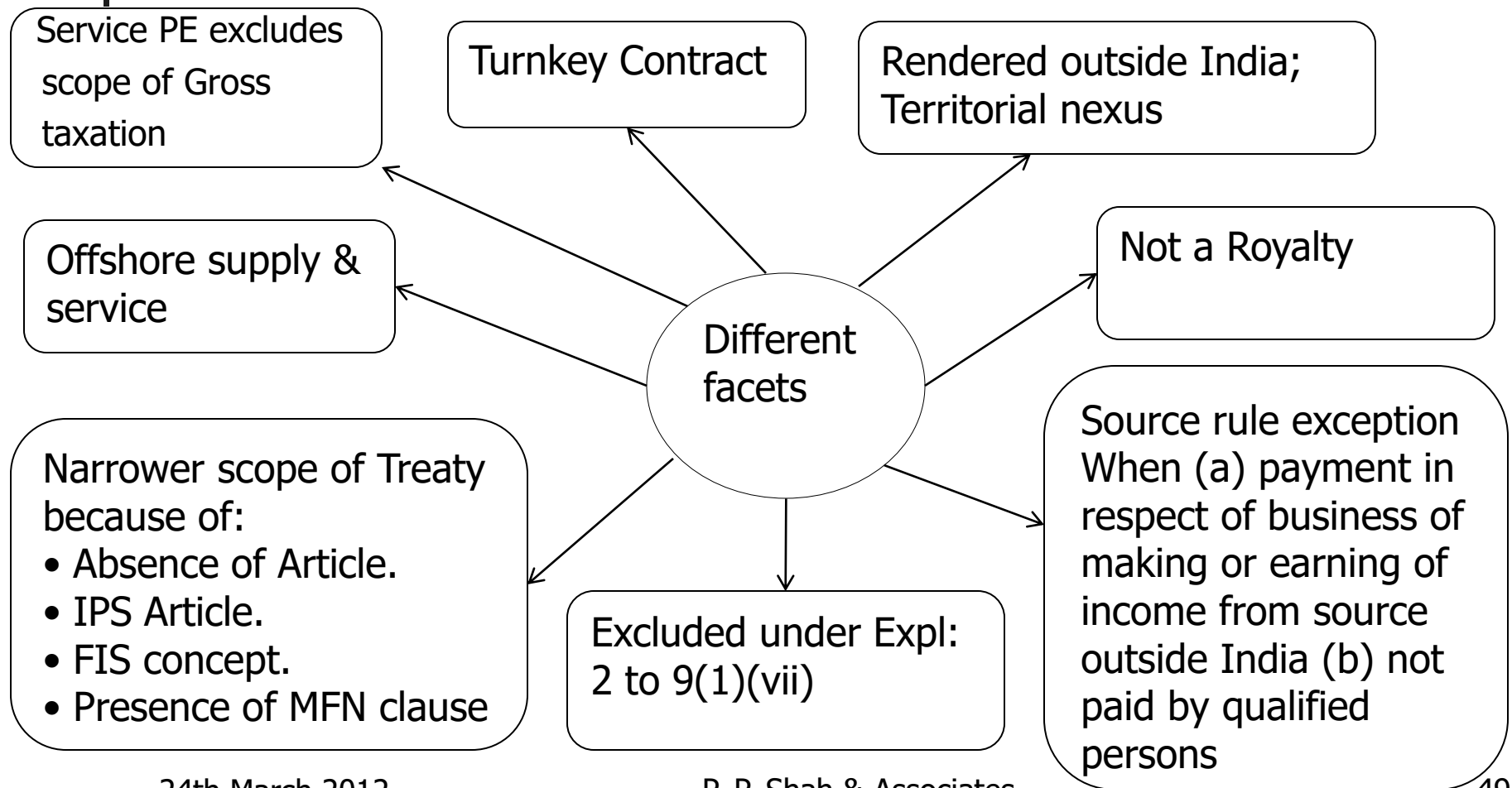
FACTS / ISSUES	RATIO
Consideration for undertaking technical services for upgrading NHAI including technical drawings, designs and reports whether FTS or 'fees for included services'?	Held to be 'fees for included services' under Article 12(2) of DTAA; when payment is for development and transfer of a technical plan / design, it need not be coupled with the 'make available' condition [SNC-Lavalin International Inc. – ITAT Delhi]
Consideration paid to French company for conducting impact tests in France on cars manufactured in India whether FTS or 'fees for included services'?	Held technical services were used in India in product development and hence payment for such technical services are liable to be taxed in India; place of accrual is determined by place where services are utilised and not where rendered [Maruti Udyog – ITAT Delhi]

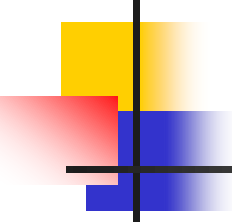


FTS: Some case studies (con't)

FACTS / ISSUES	RATIO
Consideration for support services in various fields – strategy, accounts, business development, marketing, legal, finance, etc. whether FTS?	No as services do not 'make available' technical knowledge possessed by service provider; recipient is not able to apply any technology possessed by provider [Ernst & Young (P) Ltd. – AAR]
Consideration for support services in various operational areas rendered from Netherlands whether FTS?	Yes as employees of Indian entity gets equipped to carry on the business model on their own without reference to service provider when the service agreement comes to end [Perfetti Van Melle Holding – AAR]

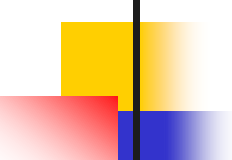
Technical Services: Different facets





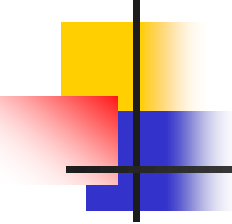
Overall scope - FTS

- Section 9(1)(vii) of the Act & DTAA
- FIS under DTAA
- Section 44D (expenses allowed up to 20% of the receipts), 44DA (similar to Article 5), 44BBB (10% of the receipts as deemed profits)
- IPS under DTAA
- Service PE clause under DTAA (Article 5)



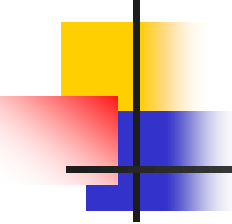
FTS: Domestic Law Tax Matrix

Receipts pursuant to agreement after 1.6.2005	Rate	Applicable Section	Basis of taxation
a) If effectively connected with PE or fixed place of profession even if Government approved or in accordance with industrial policy.	40%+s.c.	44DA	Net
b) Not effectively connected with PE	10%+s.c.	115A	Gross
i. Approved by Government or in accordance with Industrial policy			
ii. Not covered by (i.) above	40%+s.c.	S.28 r.w. amended S.44D	Net (?)
• Whether TDS necessarily @ 10% even if receipt effectively connected with FE's PE? • Applicability of Section 115A for payment by PE of FCO in India. • Allowance and reimbursements to guard.			



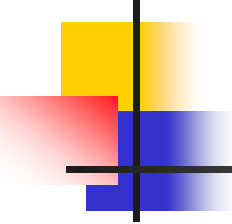
Royalty income

- Historical understanding:
 - Providing use of intellectual right for commercial exploitation gives rise to royalty.
 - Providing use on confidential basis of information or right which is not in public domain gives rise to royalty.
- Key question to be asked by recipient of consideration:
 - What does payer of consideration get in return of payment? Does the payer get use of IPR?



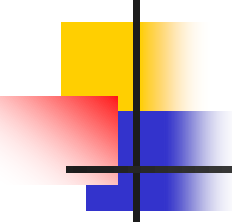
Characteristics of IPR

- IPR is result of owner's skill, effort, exertion, intellect and/or suffering.
- Owner's possession; usually, constitutes his tool of trade.
- Not in public domain; possessed secretly.
- May or may not be registered / protected.
- Licensee is permitted to do what otherwise would be infringement.
- Enabled to do what owner / licensor could have done.
- Licensee can commercialise the product.



IPR as copyright

- Literary work protected under the Indian Copyright Act [ICA].
- Literary work includes computer programme [Section 2(o) of ICA].
- Exclusive rights of “copyright” holder [section 14 of ICA] :
 - To reproduce work.
 - To issue copies to the public.
 - To make translation.
 - To make adaptation.
 - To sell or offer for sale.
- Likely overlap with sub-clause (1) of Section 9(1)(vi)

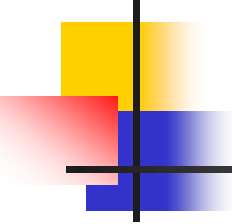


Rights of copyright holder

Underlying product	Embedded IPR content	What does Licencee of IPR expect?	What does purchaser of product get?
Medicines / Drugs	Patent	License to manufacture	Ownership of drugs
Books	Copyright	Publishing house wants right of reproduction	Ownership of book
Packaged drinking water	Trademark	Franchisee wants right to manufacture and sell under trademark	Ownership of product

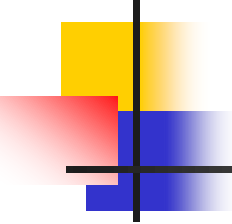
Receipt constitutes
royalty

Receipt constitutes
price



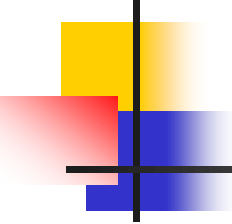
Definition of Royalty: ITA

- “royalty” means consideration (including any lump sum consideration.....) for
 - transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, secret formula or process, similar property.
 - use of any or for imparting information on working of:
 - patent,
 - invention,
 - secret formula or process,
 - similar property.
 - transfer of all or any rights (including the granting of a licence) in respect of any
 - copyright, literary, artistic or scientific work.



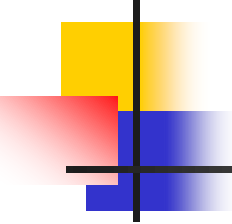
Definition of Royalty: ITA (con't)

- transfer of all or any rights (including the granting of a licence) in respect of films or video tapes for telecast or radio broadcasting.
- use or right to use equipment.
- disclosure of knowledge, experience or skill on a technical, industrial or commercial matter popularly called undivulged know-how.



Definition of Royalty: ITA (con't)

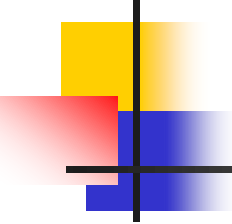
- Does not cover:
 - Payment is for business or source of income outside India.
 - Consideration for the sale, distribution or exhibition of cinematographic films.
 - Capital gains income from sale, transfer of IPR.



UN Model Definition

- Refer definition of Royalties in Section 9(1)(vi) : very wide : treaty definitions “normally” more beneficial.
- Consider : Definition of Royalties (UN Model)

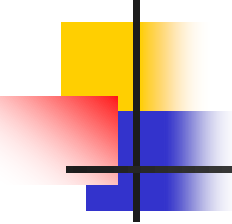
The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.



Meaning & Definition - UN Model

Meaning:

- Consideration for the use of, or the right to use :
 - a) Copyright of literary, artistic, scientific work.
 - b) Copyright of cinematograph films.
 - c) Patent, trademark, design, model, plan, secret formula, process.
 - d) Industrial, commercial or scientific equipment.
- Consideration for Information concerning industrial, commercial or scientific experience (popularly called undivulged know-how)
- What is not royalty is business income. Taxable in country of residence



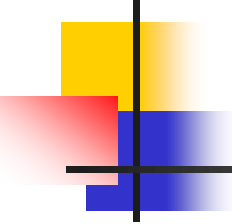
Proposal under Direct Tax Code

- The definition of the royalty under the proposed DTC is widened
- The word “secret” is now specifically restricted only to formula by inserting comma after the word formula
- The use or right to use ship or aircraft is specifically included in equipment royalty
- The use or right to use transmission by satellite, cable, optic fibre or similar technology amounts to royalty. Accordingly, payments to satellite companies, data transmission charges are now considered as royalty
- Transfer of all or any rights in respect of live coverage of an event is now considered as royalty.



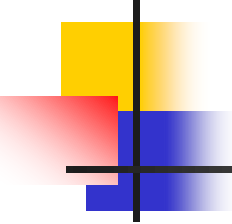
Scope of Royalty (Treaty)

Text	OECD model [Article 12(2)]	UN Model [Article 12(3)]
- means payments of any kind received as a consideration for the use of, or the right to use,	✓ ☐	✓ ☐
- Any copyright of literary, artistic or scientific work including cinematograph films,	✓ ☐	✓ ☐
- Or films or tapes used for radio or television broadcasting	X E.g. India Treaty with Belgium, Sweden	✓ ☐ E.g. India Treaty with US, UK
- Any patent, trademark, design or model, plan, secret formula or process,	✓ ☐	✓ ☐
- Or for the use of, or the right to use, industrial, commercial or scientific equipment,	X E.g. India Treaty with Belgium, Sweden	✓ ☐ E.g. India Treaty with US, UK
- Or for information concerning industrial, commercial or scientific experience	✓ ☐	✓ ☐

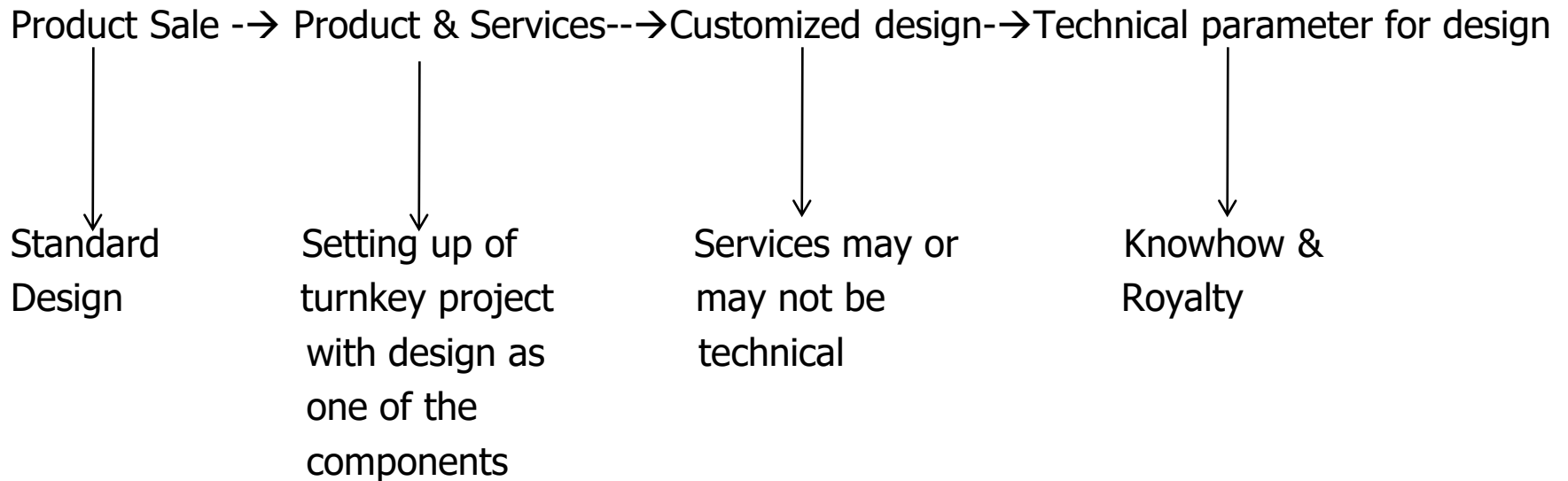


Royalty Vs FTS

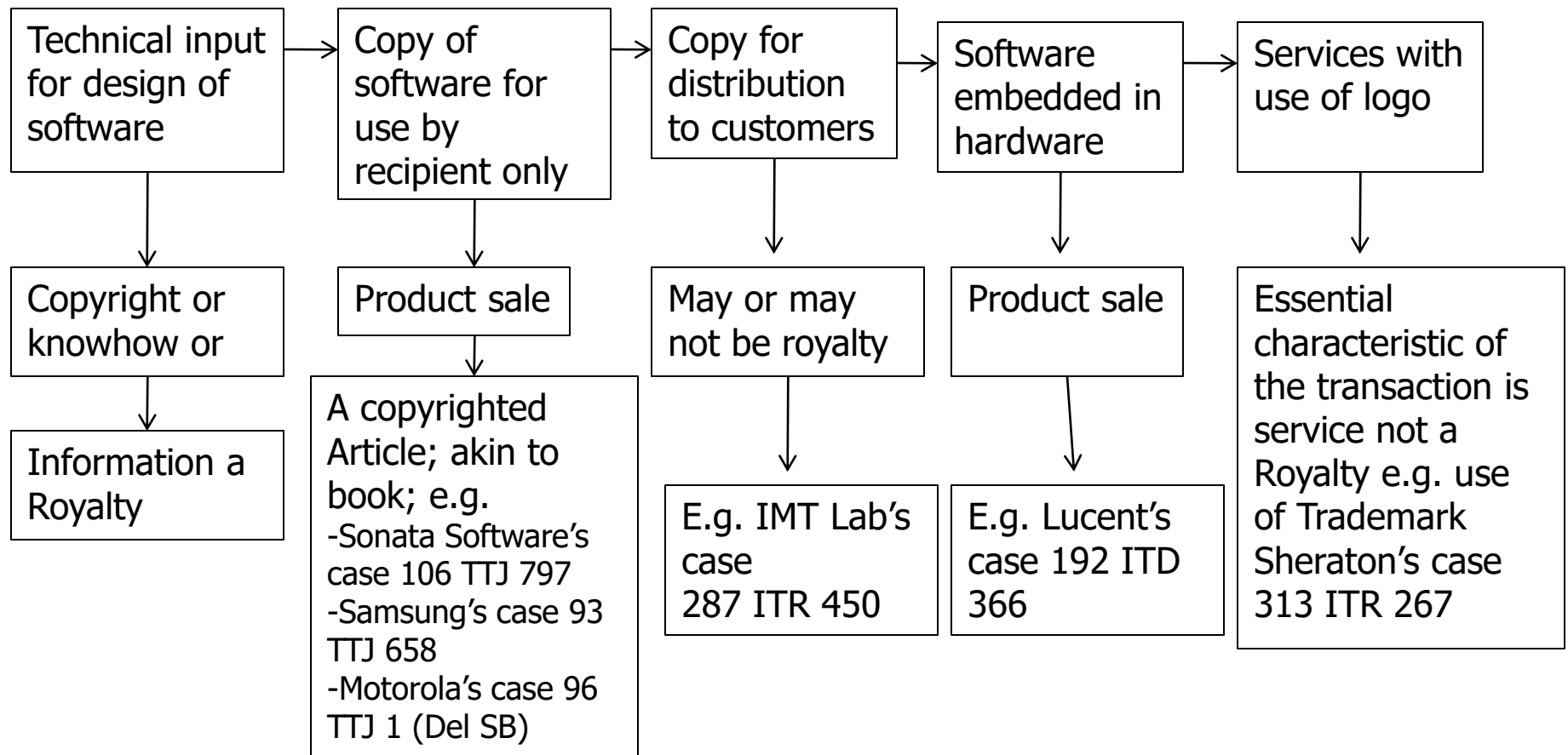
- Use of special knowledge, skill and experience by the supplier of Technical Services
- Royalty contract requires little more than the above
- Use of pre-existing knowledge in the contracts of knowhow vs contract of performance of services requires greater effort i.e. expenditure to perform
- Payments for advise electronically on standard issues arising out of supply of data base which provides uses of software with non confidential information is neither a Royalty nor a FTS – a business service

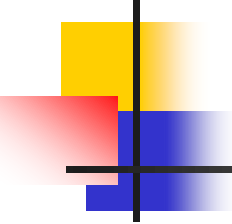


Life cycle of Services to Product



Life cycle of Services to Product (con't)





Equipment Hire Vs Service

- Consideration for use of or right to use industrial, commercial or scientific equipment

Am I acquiring use of
Equipment

Vs.

Am I acquiring service of
Equipment

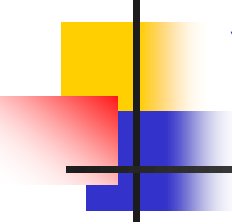
Physical possession, custody
and control of property with
user.

No concurrent user by others

Risk of operation is with the
User.

Treaties are not uniform. [Eg.
India-USA DTAA covers
equipment rental; India –
Netherlands DTAA does not.

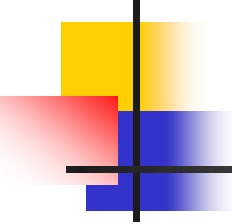
Impact of MFN clause [Belgium
treaty scope amended due to
favourable treaty with Sweden].



'Use' of equipment

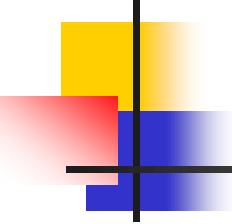
- Prior to the amendment to the definition of the term "royalty" under the Act, payment for use of equipment was outside the ambit of "royalty"
- Payment for use of equipment still outside the ambit of "royalty" under India's tax treaties with:
 - Greece, Israel and Sweden
 - Belgium, France, Kazakhstan, Netherlands and Spain (by virtue of restrictive MFN clause)

If the assessee is in the business of providing equipment on hire, then, equipment rentals not subject to tax in India if the recipient does not have a PE in India



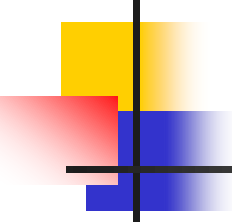
Chartering of ships, aircraft

- Certain tax treaties such as treaties with US, Canada, Singapore specifically exclude rentals for ships and aircraft from the scope of “royalty”
- International treatment: Characterization of payment, arguably, contingent on the nature of charter viz. dry lease or wet lease -
 - Dry lease: generally regarded as payment for “use of equipment” and hence, royalty
 - Wet lease: generally regarded as profit from shipping activity and hence, covered by Article 8
- Recent decisions of the Chennai Tribunal:
 - West Asia Maritime Ltd v. ITO 109 TTJ 617: payment for bareboat charter demise (dry lease) regarded as royalty
 - Poompuhar Shipping Corporation Ltd v. ITO 108 TTJ 970: payment for time charter (wet lease) regarded as royalty



Features of an “outright purchase” arrangement

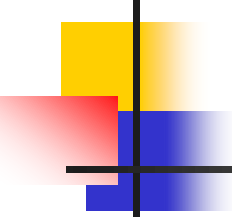
- Salient features of an “outright purchase” arrangement:
 - Transfer of property in the designs and drawings to the buyer
 - No rights in the designs and drawings retained by the seller
 - ‘Ownership’ rights with the buyer to sell or transfer the property as he likes
 - Price determined upfront and not subject to escalations
 - Any deficiencies in the property have to be completed or corrected by the seller
 - Payment to be made irrespective of the use of the property



Judicial precedents

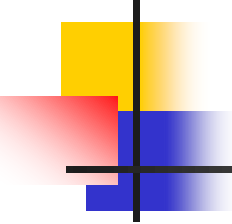
- In favour of assessee
 - CIT v Davy Ashmore India Ltd 190 ITR 626 (Cal)
 - Pro-quip corporation v. CIT 255 ITR 354 (AAR)
 - DCIT v. Finolex Pipes Ltd 106 TTJ 741 (Pune)
 - Abhishek Developers v. ITO 110 TTJ 698 (Blr)
 - CIT v. Nevyli Lignite Corporation Ltd 243 ITR 459 (Mad)
 - CIT v. Koyo Seiko Co. Ltd 233 ITR 421 (AP)
 - CIT v. Klayman Porcelains Ltd 229 ITR 735 (AP)

- In favour of revenue
 - DCIT v. All Russia Scientific Research Institute 98 ITD 69 (Mum)
 - Leonhardt Andra Und Partner GmbH v. CIT 249 ITR 418 (Cal)



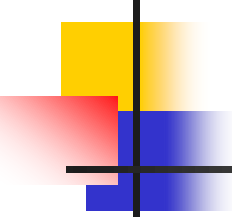
Characterisation of E-commerce transactions

- Controversy essentially around whether such transactions fall within the ambit of 'royalty' or 'business profits'
- OECD-TAG report (2001)
 - Advocating principles of neutrality, efficiency, flexibility, certainty, simplicity, effectiveness and fairness
 - Taxability of a transaction should not be colored by the mere fact that it is effected electronically
 - E-commerce transactions essentially involving payment for use of copyright to be regarded as royalty; if payment essentially for copyrighted article, then, income to fall within the ambit of 'business profits'
- HPC report (2001)
 - While HPC has expressed conformity with OECD principles, it has changed characterization where the mode of delivery is digital; certain HPC characterization in conflict with OECD Commentary and accepted principles on Article 12



Transactions

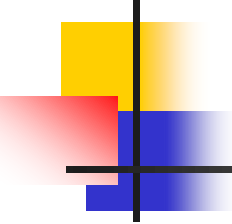
- Sale of Business Information Reports
- Use of electronic database
- Payment for accessing web portal
- Payment for online data processing
- Commercial information
- Bandwidth charges



Turnkey services

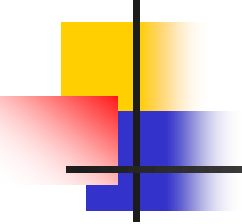
- Turnkey arrangement with Raytheon-Ebasco for setting up power plant
- Consideration segregated between supply of equipment and spares, technical services and start-up services/turnkey responsibility
- As regards technical services and start-up services, the Tribunal held:
 - Consideration does not fall within the ambit of exclusion from FTS under the Act (consideration for construction, assembly, mining or like project)
 - Rendering of services not inextricably linked to supply of equipment (which equipment supplier Raytheon-Ebasco had to chose)
 - Services relate not only to supply of equipment but also extend to setting up of the power plant
 - Services involve making available technical knowledge, experience, know-how, processes
 - Services fall within the ambit of FIS under the India US Tax Treaty

Jindal Tractabel Power Co Ltd v. DCIT 106 TTJ 1011 (Blr)



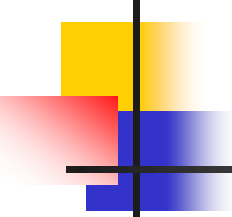
Nature of Payments & its Taxation

- Band with charges
- Up-linking & down-linking facilities through international leased lines
- Payment for end to end communication link through internet
- Payment for the use of transponder
- Access and use of portal for booking cargo and tickets

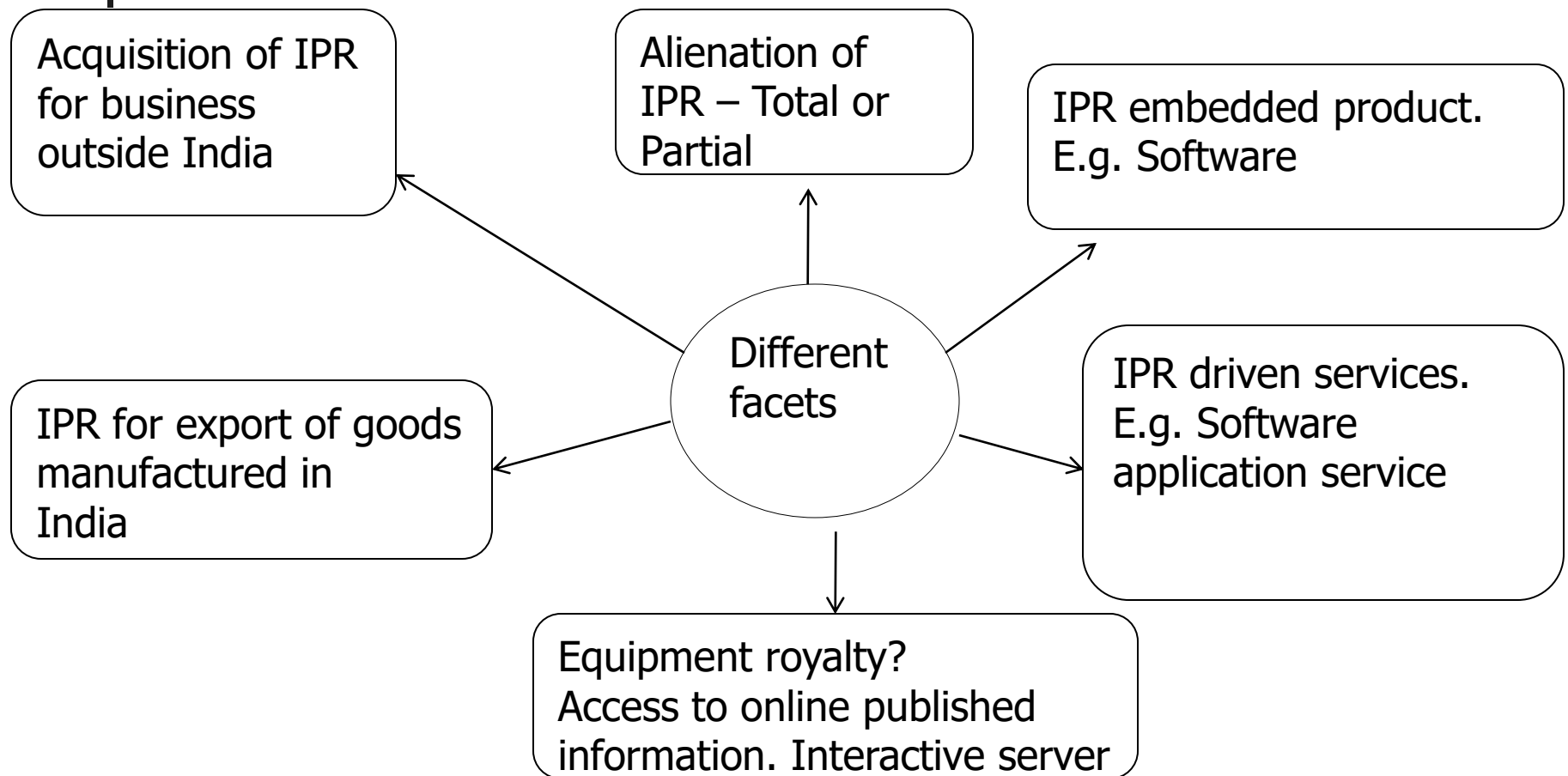


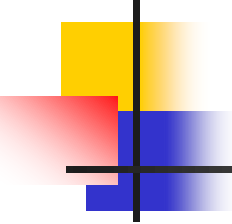
Nature of Payments & its Taxation

- Off the shelf software
- Purchase of Equipment with embedded software or software to use the equipment
- License to use software for the purposes of the business of the payer
- Access to information report to a subscriber
- Payment for data processing



Royalty: Different facets

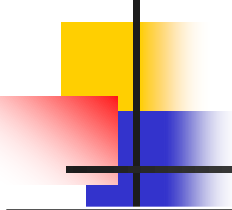




Survey of India's Treaty - Illustrative

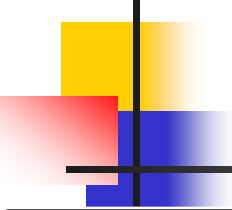
India's Treaty with FIS Clause:

- US, UK, Singapore, Switzerland, Cyprus with Technical and Consultancy services as technical services
- UN Model treaty: Bangladesh, Belgium, Brazil, Canada, China, Cyprus, Czecho-Slovakia, Denmark, Finland, France, Germany, Hungary, etc
- DTC with Australia uses the word: Royalties to which a resident of other contracting state is beneficially entitled
- Variation is found on the various aspects such as
 - Absence of use of equipment, variation in use of cinematographic films, OECD definition, only source taxation in certain types, Resident vs Beneficial owner, Service Rule



OECD Model Commentary - India's position

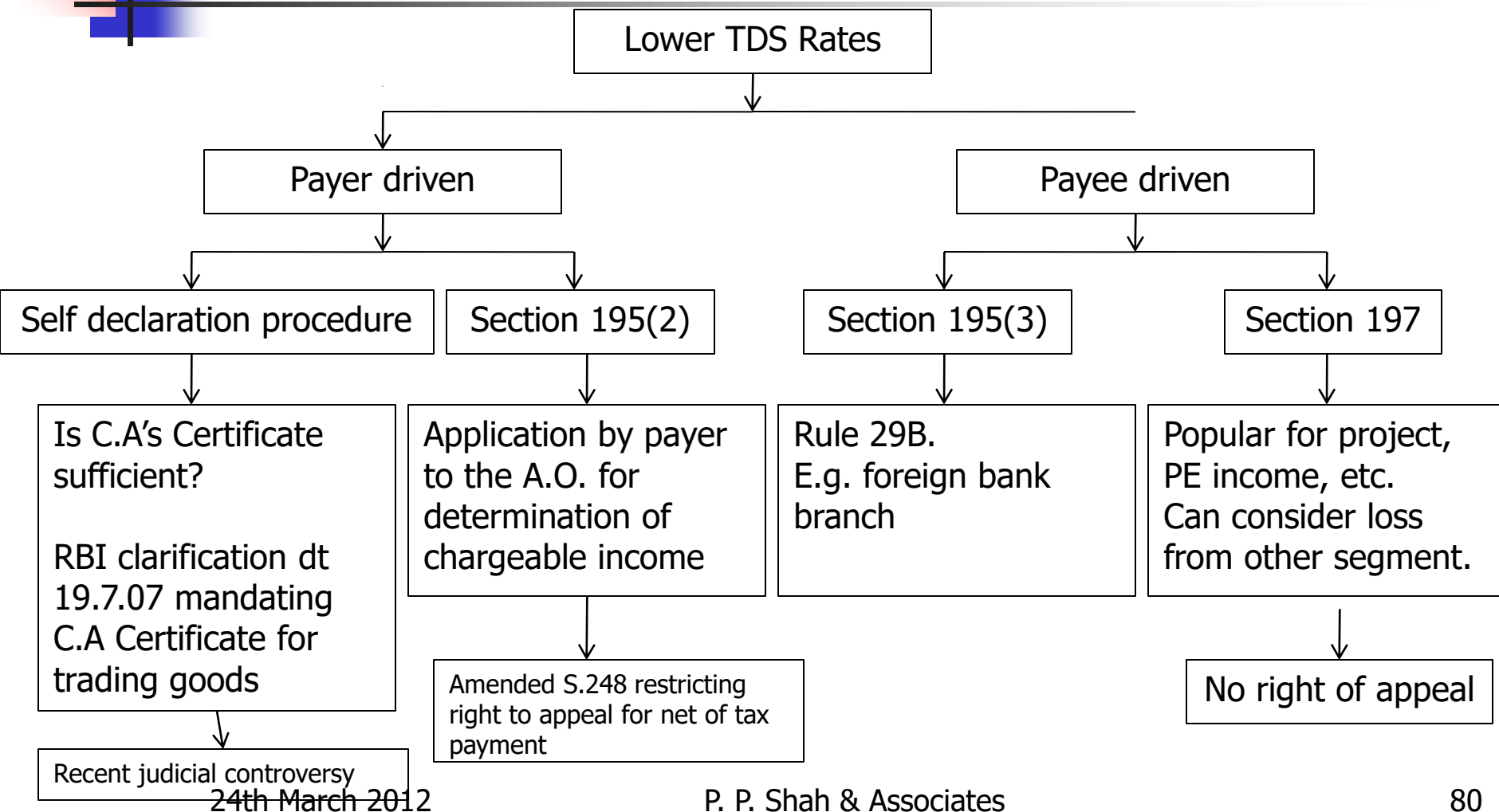
OECD Position	India Position
Transfer of full ownership of an element of property referred in the definition “royalties” (Para 8.2)	
Payment not for use of or the right to use – hence not royalty- Article 7 / 13 to apply	May constitute royalty
Payment for obtaining exclusive territorial distribution rights of a product / service (Para 10.1)	
Not royalty – payments to increase sales receipts – Article 7 to apply	May constitute royalty
Payment for the development of design , model or plan that does not already exist (Para 10.2)	
Not royalty – payments to create new design /model – Article 7 to apply	May constitute royalty
Act of copying programme for effective operation of programme by the user (Para 14)	
Not royalty – Article 7 to app	May constitute royalty

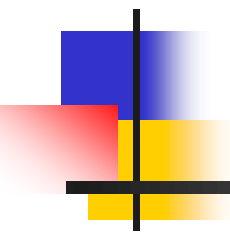


OECD Model Commentary - India's position – con't

OECD Position	India Position
Method of transferring the computer programme (Para 14.1)	
Not relevant – no royalty	May constitute royalty
Site licenses, Enterprise licenses, network licenses - Facilitating effective user – reproduction for other purposes restricted (Para 14.2) (Like multi user licences)	
Not royalty – Article 7 to apply	May constitute royalty
Distribution intermediary – distribution of software copies (Para 14.4)	
Not royalty –Article 7 to apply	May constitute royalty
Transfer of full ownership rights (Para 15 & Para 16)	
Not royalty – Article 7 / Article 13 to app	May constitute royalty
Downloading digital products for obtaining and using required data (Para 17.3)	
Not royalty –Article 7 to apply	May constitute royalty

TDS Obligation





Thank You
