International Fiscal Association

Taxability of royalty payments as explained by the Courts

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Speaker – Mr. Ajay Vohra, Sr. Advocate

Moderators – Dr. Shashwat Bajpai and Ms, Ishita Farsaiya

Introduction –

- Through this session we seek understand the conceptual aspects arising with respect to the taxability of payments amounting to royalty as per Section 9 (vi) of the Income Tax Act, 1961 and the Article 12 (reference to OECD and UN Model Convention
- This session is divided into three sub- sessions
- We request you all to make this session as interactive as possible but would request you to limit your questions only to the discussion at hand.

RELEVANT PROVISIONS

Article 12

OECD Model

- *Article 12 (2) – 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, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.*

UN Model

- *"12 (3) ---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, 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."***

Royalty as defined under the Income Tax Act, 1961 (‘the Act’)

Section 9 of the Act talks about Income accrued in India. **Explanation 2 to Section 9 (1)(vi)** is relevant in the present case as it entails the definition of royalty.

Explanation 2- For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—

(i). the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property ;

(ii). the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property ;

(iii). the use of any patent, invention, model, design, secret formula or process or trade mark or similar property ;

(iv). the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill ;

(iva) the use or right to use any industrial, commercial or scientific 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, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films ; or

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

Clarifications added by amendments

Explanation 3.—For the purposes of this clause, "computer software" means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data. *(Inserted in 1991 and amended in 2000)*

***Explanation 4*.—**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.

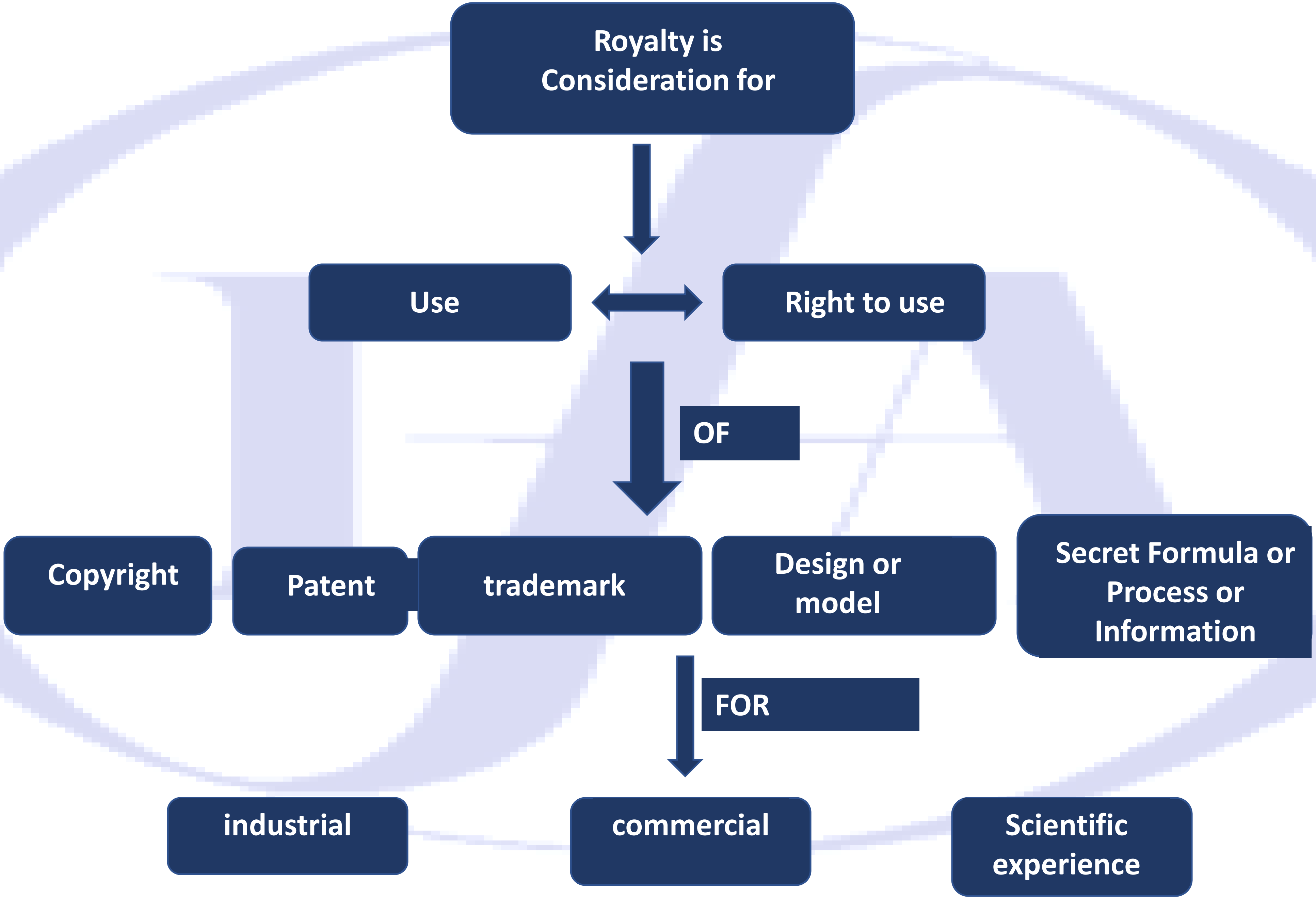
***Explanation 5*.—**For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—

(*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; ***(Explanation 4,5 and 6 are Inserted by Finance Act 2012 w.e.f. 1/6/1976)


Royalty is Consideration for
Use
Right to use
OF
Copyright
Patent
trademark
Design or model
Secret Formula or Process or Information
FOR
industrial
commercial
Scientific experience

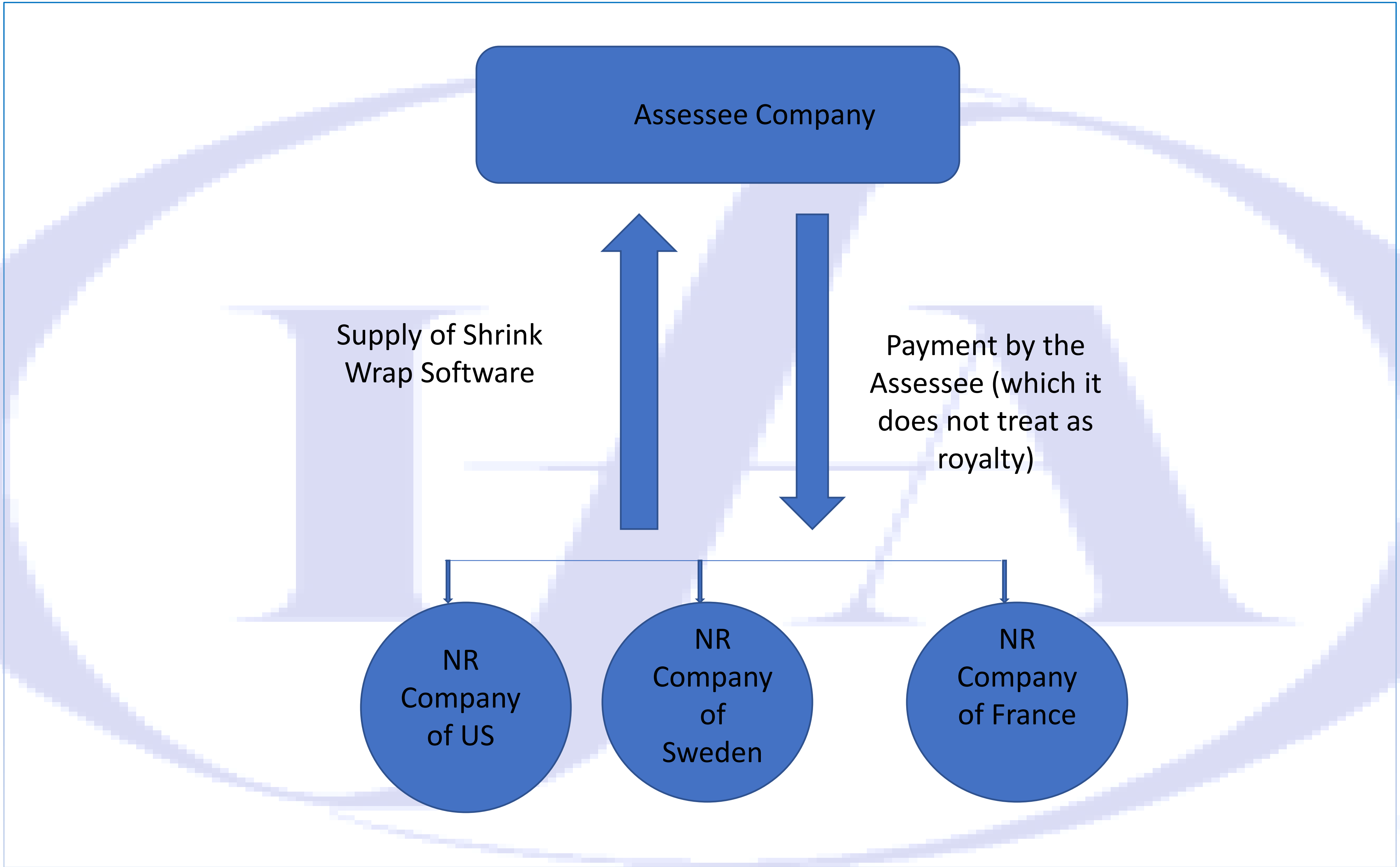
Session 1- Payment for “use” of software whether it constitutes royalty or not (Clause (v) of Explnation 2 of Section 9 (1) (vi)

- On this issue the Karnataka High Court in ***CIT v. Samsung Electronics Co. Ltd. [2012] 345 ITR 494 (Kar.)*** and ***Commissioner of Income tax vs. Synopsis International Old Ltd. [2012] 28 taxmann.com 162 (Kar.)*** took a view in favour of the Deptt
- The Delhi High Court in ***Director of Income-tax vs. Infrasoft Ltd., [2013] 39 taxmann.com 88 (Delhi)*** took a view in favour of assessee.
- SLPs against the matter are now pending before the Supreme Court
- A major topic of discussion here is the taxability of a payment for ***use of a copyright vs. use of a copyrighter article***

CIT v. Samsung Electronics Co. Ltd.

FACTS

- The assessee company is a distributor of imported software. The software is a shrink wrap package.
- In the present case the assessee company imported the shrink wrap software from non resident companies and made payments for it not being royalty according to the assessee whereas the revenue contends that the payment made to the foreign suppliers in lieu of the software is royalty on which TAS was to be deducted under Article 12 of DTAA.
- The A.Y. in consideration was 1999-2000 to 2001-2002.
- Payment for importing software by the assessee was made of Rs. 2,28,960/-, 10,825/- and 1,51,85,430/- for the AYs 1998-99. 1999-2000 and 2001-01 respectively.
- The A.O. held that since use of software requires license, the payment made for purchasing the shrink wraps is in the nature of royalty, therefore TAS was liable to be deducted by the assessee company.
- The Commissioner (Appeals) upheld the order of the A.O.
- In the appeal before ITAT, the Tribunal held that payment made by assessee does not amount to royalty.
- In the Karnataka High Court, the Court without getting into the merits of the case ordered that TAS was payable as there was a remittance to the foreign suppliers. The appeal against this went to SC wherein the Court remitted the matter to Karnataka HC for consideration.


Assessee Company
Supply of Shrink Wrap Software
Payment by the Assessee (which it does not treat as royalty)
NR Company of US
NR Company of Sweden
NR Company of France

Arguments advanced

- Assessee

1. The payment would not amount to ‘royalty’ within the meaning of Section 9(1)(vi) as the transaction was in the nature of a sale and not a license. No copyright or part of any copyright has been licensed to the assessee and the sale was off the shelf.
2. That the proprietary rights in the software continued to subsist with the non-resident owner and the use of the software by the assessee was limited to making backup copy and redistribution.
3. The assessee relied on TCS v. State of Andhra Pradesh where the Supreme Court held that in a transfer of incorporeal right in a software wherein copyright remains with the originator, what is actually sold is the copy of the copyrighted software and not the copyright itself.
4. The assessee also relied on OECD commentary and other Supreme Court judgments to establish that only copies of the software were procured and not the copyright itself. Even though the agreement with the non-resident company uses the word ‘license’, there is no license or assignment involved in the transaction as per the Copyright Act.
5. That the assessee was involved only in handing over the articles to the ultimate customers and at times the article was directly sent to them and as such the assessee did not use the software involved.

- Revenue

1. The revenue argued that even if it was a sale, it would still be taxable in India as business income even without a permanent establishment .
2. The revenue further averred that the transaction was in fact a license agreement since the rights granted to the assessee would not have been available had it not been the said agreement, therefore, the payments would amount to royalty and not sale.
3. The revenue also distinguished the case of TCS (on which the assessee was relying) that the issue was in relation to sales tax in the TCS case and not on direct tax and royalty.
4. That even if the payment was made for use of copyrighted article, then in view of the explanation in section 9(1)(vi) of the Act, ‘royalty’ means consideration including lump sum payment for transfer of all or any rights for imparting any information concerning the use of copyright work in which copyright vests with the non-resident company.

License agreement -

- Non-Exclusive and Not Transferrable and software has to be used in accordance with the agreement.
- Only 1 copy and that too include INFRASOFT'S copyright.
- Exclusive property of INFRASOFT.
- Use : Licensee's own business.
- Restriction to make copies, disassemble, or reverse engineer the software without Infrasoft's written consent.
- All copyrights and intellectual property rights in and to the Software, and copies made by Licensee, were owned by or duly licensed to Infrasoft

RULING OF THE COURT

According to the Explanation 2 to of Section 9(1)(vi) and Article 12 of DTAA, the payment made by the assessee company in lieu of the shrink wrap software falls within the purview of royalty.

The tribunal was not justified in holding that the amount was not royalty and not taxable.

Assessee is liable to deduct Tax at Source

Para 20. It is well settled that copyright is a negative right. It is an umbrella of many rights and licence is granted for making use of the copyright in respect of shrink wrapped software/off-the-shelf software under the respective agreement, which authorizes the end user i.e., the customer to make use of the copyright software contained in the said software, which is purchased off the shelf or imported as shrink wrapped software and the same would amount to transfer of part of the copyright and transfer of right to use the copyright for internal business as per the terms and conditions of the agreement. Therefore, the contention of the learned senior counsel appearing for the respondents that there is no transfer of copyright or any part thereof under the agreements entered into by the respondent with the non-resident supplier of software cannot be accepted. shrink wrapped software/off-the-shelf software

Para 24. It is clear from the provisions of the Copyright Act that the right to copyright work would also constitute exclusive right of the copyright holder and any violation of the said right would amount to infringement under section 51 of the said Act. However, if such copying of computer programme is done by a lawful possessor of a copy of such computer programme, the same would not constitute infringement of copyright and wherefore, but for the licence granted in these cases to the assessee to make copy of the software contained in shrink- wrapped/off-the-shelf software into the hard disk of the designated computer and to take a copy for back-up purposes, the end user has no other right and the said taking back-up would have constituted an infringement, but for the licence. Therefore, licence is granted for taking copy of the software and to store it in the hard disk and to take a back-up copy and right to make a copy itself is a part of the copyright. Therefore, when licence is granted to make use of the software by making copy of the same and to store it in the hard disk of the designated computer and to take back-up copy of the software, it is clear that what is transferred is right to use the software, an exclusive right, which the owner of the copyright, i.e., the supplier owns and what is transferred is only right to use copy of the software for the internal business as per the terms and conditions of the agreement.

Commissioner of Income tax v. Synopsis International Old Ltd.

- **FACTS**
- The assessee company (Irish), was granted a license to use and commercially exploit the intellectual property in the Electronic Design Automation ('EDA') Tool and Software in certain geographies by Synopsis U.S., who was the owner of tool/Software.
  - The Integrated Circuit (IC) manufacturers follow design flow process before fabrication of IC's and EDA tools are used in this design flow process.
- The owner company required the assessee company to enter into End User Software License Agreement (EULA) with customers for protecting its rights in the products, documentation and the intellectual property in the software.
- Per agreement, a customer purchased a licensed product i.e. EDA tool/software from assessee.
- For payments received in consideration for such sale, the Assessing officer exercising his powers taxed such income for relevant assessment years.
- In Appeal, the CIT concurred with the assessment of A.O.
- In further appeal to the ITAT, the assessment orders were overturned on the premise of transfer of copyrighted article and not the copyright itself

- **In Appeal to the Hon’ble High Court, following issues were raised:**

  - Whether the consideration paid by the Indian customers or end-users, to the assessee for transfer of the right to use the software/computer programme was in respect of the copyright and falls within the mischief of 'Royalty' as defined under sub-clause (v) to Explanation 2 to clause (vi) of section 9(1) of the Act?

  - Whether the consideration paid to the owner or a licensor of a copyright, for permission to use the software/computer programme was a consideration for transfer of any right in respect of a copyright and falls within the mischief of the definition of 'Royalty’?

RULING

- The words non-exclusive and non-transferable as used in the End-User Software Licence Agreement, does not take away the software out of the definition of the copyright.
- The right to use the confidential information embedded in the software in terms of the licence agreement makes it clear that there is transfer of certain rights which the owner of copyright possess in the said computer software/programme in respect of the copyright owned.
- Perusing the terms of relevant DTAA, it was held that the consideration paid for use/ right to use confidential information in form of computer programme software constitutes ‘Royalty’. It is not necessary that there should be a transfer of exclusive right in the copyright.
- Therefore, under Explanation (2) of clause (vi) of sub-section (1) of section 9 of the Act such payments/ consideration are to be regarded as Royalty and are liable to be taxed.

Director of Income-tax vs. Infrasoft Ltd. ,[2013] 39 taxmann.com 88 (Delhi)

1. The assessee was an international software marketing, and development company and its holding company was based in US namely Infrasoft Corporation.
2. The assessee was developing customized software to be used for designing highways, railways, airports, ports, mines, etc. The software so customized was licensed to an Indian customer and the branch office of the assessee in India performed services involving interface to peripheral installation and training etc.
3. In course of assessment, the Assessing Officer taxed the receipts on licensing the software as 'royalty‘ as per article 12 of Indo-US DTAA.
4. The Commissioner (Appeals) upheld the order of Assessing Officer.
5. The Tribunal, however, held that the amount received by the assessee under the license agreement for allowing the use of the software was not royalty either under the Act or under the DTAA.

Issue: ***Whether income received by way of consideration for grant of licenses for the use of software is royalty under Article 12 of DTAA?***

Arguments advanced

- Assessee

- What was transferred was neither the copyright in the software nor the use of the copyright in the software, but what was transferred was the right to use the copyrighted material which was clearly distinct from the rights in a copyright.

- That no doubt, if right to use the copyright had been transferred, the same would give rise to royalty. But where right that is transferred is not a right to use the copyright but is only limited to the right to use the copyrighted material, the same would not give rise to any royalty income and would be business income.

- Revenue

- Right to use of software under the software license agreement resulted in earning of royalty income.

- Computer software is one of the intellectual property referred to in the Explanation 2 to section 9 (i) (vi) and transfer of rights therein by the licensor would give right royalty income.

- Relied upon the decision of the Karnataka High Court in the case of CIT v. Samsung Electronics Co. Ltd [2012] 345 ITR 494 (Kar.) to contend that right to make a copy of the software and storing the same in the hard disk of the designated computer and taking backup copy would amount to copyright work under section 14(1) of the Copyright Act and the payment made for the grant of the licence for the said purpose would constitute royalty.

Key aspects in Infrasoft

- In the instant case there was no transfer of all or any right in respect to copyright in literary, artistic or scientific work.
- License granted by the assessee was necessary for utilization of the computer programme.
- Royalty paid on transfer of copyright vs. Consideration for transfer of copyrighted article.
- NO transfer of any right in respect of copyright vs. Mere transfer of copyrighted article.
- In the instant case there was no transfer of Copyright rather there was merely transfer of copyrighted article.
- Right to use copyright vs. Right to use programme embedded in a cassette or C.D.
- Court held that the income is not royalty as the transfer was not of any right in copyright but rather there was only transfer of copyrighted article and hence income of assessee shall be taxed under Article 12 of DTAA.

Decision - What has been transferred is not copyright or the right to use copyright but a limited right to use the copyrighted material and does not give rise to any royalty income.

- Reasons given by the Court
  - Distinction between acquisition of a "copyright right" and a "copyrighted article".
  - Distinction between royalty paid on transfer of copyright rights and consideration for transfer of copyrighted article.
  - There is no transfer of any right in respect of copyright by the assessee and it is a case of mere transfer of a copyrighted article.
  - The payment is for a copyrighted article and represents the purchase price of an article and cannot be considered as royalty under the Income IT Act or under DTAA.
  - The incorporeal right to the software i.e. copyright remains with the owner and same was not transferred by the assessee.
  - That the DTAA overrides the Article

Licensee not allowed to EXPLOIT IT COMMERCIALLY

INCORPOREAL RIGHT to the software which is copyright right remains with the owner.

94. The incorporeal right to the software i.e. copyrighter mains with the owner and the same was not transferred by the Assessee. The right to use a copyright in a programme is totally different from the right to use a programme embedded in a cassette or a CD which may be a software and the payment made for the same cannot be said to be received as consideration for the use of or right to use of any copyright to bring it within the definition of royalty as given in the DTAA. What the licensee has acquired is only a copy of the copyright article whereas the copyright remains with the owner and the Licensees have acquired a computer programme for being used in their business and no right is granted to them to utilize the copyright of a computer programme and thus the payment for the same is not in the nature of royalty.

Session 2 – When does payment for use of equipment amount to royalty (Clause (iva) of Explanation 2 to Section 9(1)(vi))

Verizon Communications Singapore Pte Ltd. vs. Income Tax Officer, International Taxation-I, [2014] 361 ITR 575 (Madras) – In favour of revenue

versus

Director of Income-tax vs. New Skies Satellite BV, [2016] 382 ITR 114 (Delhi) – In favour of the assessee

Verizon Communications Singapore Pvt. Ltd.
v.
The Income Tax Officer

J. CHITRA VENKATARAMAN and
J. T.S.SIVAGNANAM

- **High Court of Madras**
- **07.11.2013**

Facts

- The assessee company, Verizon Communication Singapore Pte Limited originally called as MCI WorldCom Asia Pte Limited, is a non- resident company engaged in the business of providing international connectivity services. (IPLC)
- IPLC (International Pvt. Leased Circuit): an end to end managed dedicated bandwidth service that provides internet service to customers for various applications. The international leg of the telecom services provided outside India is provided by the assessee.
- It is stated that the gateway/the landing station in India used in transmitting the traffic within India belonged to VSNL and is used by VSNL for providing Indian end services pursuant to its contract with the customer.

Assesse Company
VERIZON Communication Singapore Pte Limited (MCI Worldcom Asia Pte Limited)

→

VSNL (Videsh Sanchar Nigam Limited)
Indian leg of international services to Indian customers

***NOTE-** A customer interested in taking a lease connection between its office in India and an overseas location had to enter into an arrangement with the assessee for the provision of international connectivity in the overseas leg and with VSNL for Indian half of the connectivity.

*Assesse not being a licensed service provider in India

ISSUES

Whether the Tribunal was right on facts and in law in holding that the payments received by the appellant from the Indian customers for provision of Bandwidth/Telecom Services outside India is royalty for the 'use of, the right to use equipment' u/s 9(1)(vi) of the Act?

Whether these payments received constitute royalty for the 'use of, or the right to use equipment' u/s 12(3)(b) of the Tax Treaty(DTAA between India and Singapore)?

Contentions Raised By The Assessee Before AO, CIT and ITAT:

Revenue earned by the assessee could not be considered as 'royalty' paid for the use of the equipment under the Income Tax Act:

1. As the **customers have no knowledge of the equipment/network used by the assessee** for the provision of the service;
2. That **the customers do not have the control with reference to the usage of the equipment/network** used for rendering the service.
3. That **no part of the international network is exclusive for any Indian customer or customers as a whole.**
4. The **agreement between the assessee and the customers being one for rendering of service by the assessee**, the payment could not be termed as 'royalty'.
5. That **it used telecom service equipment which is situated outside the territory of India** to provide international connectivity service and **that they do not utilise any landing station in India for providing international half circuits**. The **gateway in India used in transmitting the traffic within India belonged to VSNL.** This is used by VSNL for providing Indian end services pursuant to the contract it has with the customers.

TRAIL OF THE CASE

1. ASSESSING OFFICER:

Contentions of AO-

1. the receipt of **consideration** for rendering of services to the end user is workable only when the assessee and the VSNL are considered to be rendering the service jointly to the end user in India.

2. **The agreements between the assessee and the end user and the VSNL are part of one transaction, but executed through several agreements/arrangements.** The payments made by the customers for the offshore services rendered by the non-resident assessee are part of one single agreement to provide IPLC and hence, the receipts are taxable as 'royalty' under Section 9(1)(vi) read with Explanation 2 of the Income Tax Act.

3**. The transmission cables and hightech instruments providing a seamless circuit are 'equipment'** and the income earned by permitting the use of or right to use of equipment fell within the meaning of 'royalty', both under the Income Tax Act and under the DTAA between India and Singapore.

DECISION:

- Payment received by the assessee in providing IPLC was taxable as 'royalty' **for use of or right to use of commercial and scientific equipment under Section 9(1)(vi) read with Explanation 2** of the Income Tax Act and **Article 12(3) of the Double Taxation Avoidance Agreement (DTAA)** between India and Singapore.
- Held that : **VSNL and MCI Worldcom Asia Pte Ltd are partners in providing IPLC** and related services to various customers; **the assessee has business connection in India on account of the source of income and location of the business assets** and software in India.
- Thus, the payments were in the nature of 'royalty', taxable under Section 9(1)(vi) read with Explanation 2(iva) and (vi) as also under Article 12(3)(b) of DTAA with Singapore.

2. CIT –

- Confirmed the order of the AO for the assessment years under consideration.
- Pointed out to **the various clauses in the agreement between the assessee and the customer and VSNL**, the Master Service Agreement, technology agreement between the assessee and VSNL and MCI Global Access Corporation (WCom), **the support services agreement with the assessee affiliates and held that the circuit created/developed by MCI, comprising of transmission cables and sophisticated instruments, amounted to 'equipment'.**
- **The payment made for the lease of this circuit, which expressed the quantity of dedicated bandwidth**, would be taxable as 'royalty' under Section 9(1)(vi) Explanation 2 as well as under DTAA. Thus, the first Appellate Authority rejected the appeals.

3. ITAT

- As per the agreement, the **customer acquired significant, economic or possessory interest in the equipment of the assessee to the extent of the bandwidth hired by the customer.** This was made available to the assessee on a dedicated basis.
- The agreement with VSNL for split billing is only to overcome the telecom regulatory regime prevailing in India.
- Held that even if the payments are not treated as not relating to the use of the 'equipment', **they should be considered as payment for the use of the 'process'.**
- Held that the payments made are for the use of tangible equipment and hence could be considered as payment for the use of or right to use of industrial, commercial and scientific equipment.
- The dedicated bandwidth is set aside by the service provider for the exclusive use of the customer.

The Tribunal confirmed the views of the Assessing Officer. Thus, the appeals were rejected. Hence, the Present Petition

Arguments by the Assessee before the high court:

I. AGREEMENT IS FOR PROVIDING THE SERVICES:

- Going through various clauses in the agreements, submitted that **considering the fact that the contract between the assessee and the customer being one for providing services,** the consideration received for rendering of services cannot be termed as 'royalty'
- Based on **Explanation 2 to Section 9(1)(vi) of the ITA**. The enumeration in Explanation 2 clearly indicates that the royalty has to be given a **limited meaning** only, w.r.t tangible and intangible right, property or info. The Explanation says nothing about treating the consideration on rendering of services as 'royalty'. Statutorily**, rendition of services is dealt with under sub- clause (vii) to Section 9(1) of the ITA**. Even as per this, the receipt cannot fall under sub-Clause (vii).
- Thus, the assessee renders the service of transmitting the customer's information from one location to another and the customer **does not make the payment for acquiring a process, but only for a facility to communicate.**
- He further pointed out that failure to render or any deficiency in service resulted in non-payment of the consideration.

II. DTAA:

- **Article 12(3) and 12 (4)** of the tax treaty deals with payments of royalties and fees for technical services.
- **The payment does not answer the meaning of 'equipment royalty',** since the common understanding is that rendering of service by the provider using the equipment under his possession, control or use would not constitute 'royalty'.
- The nature of services rendered providing access to service to many customer with the same equipment thus takes the case of the assessee outside the scope of the taxing provisions.

III. ‘ACCESS TO SERVICE’ IS DIFFERENT FROM ‘ACCESS TO RIGHT TO USE THE EQUIPMENT’ :

- The service rendered is **on non-exclusive basis and half circuit in India is operated by VSNL.**
- In this, the customer does not get any right to use any equipment or has any knowledge or interest in the process/technical equipment deployed by the assessee in providing the service.
- Even though the assessee provides end to end service, it has nothing to do with the maintenance or providing service by VSNL. Whatever bandwidth is assured is again a shared one **There are no equipment strictly speaking of the assessee** to process the data of the customer.
- Network equipment remained under the possession, control, operation and use of the assessee and VSNL respectively and the same is never handed over at any point of time to the customers

IV. ARRANGEMENT IS BASED ON DOMESTIC LAW:

- The payment could not be brought under the head of 'royalty .The arrangement between the assessee and VSNL is a bona fide one based on domestic law. The assessee is not a party to the agreement between MCI Global Access Corporation (Wcom) and VSNL and MCI Global Access Corporation (Wcom) had sold the nodal equipment to VSNL .
- The Revenue has misconstrued the facts and the sophisticated **technology merely concerns transmission of the data without distortion and the VSNL provided independent services within the Indian territory** and is paid for separately and directly by the customers.
- As the assessee required to provide the bandwidth services to customers in India for providing and ensuring the seamless performance/delivery of bandwidth services. **not having the necessary license under the regulatory laws of India, it entered into an agreement with VSNL.**
- Thus, the respective service provisioning entities, namely, the appellant outside India and VSNL within India provide the services in their respective areas. **Consequently, the question of treating their receipts as 'royalty' did not arise.**
- The assessee secures the information and the data and maintains confidentiality and provides mirror image of what is given by VSNL outside India. In the background of this process to provide high-quality service to the customers, the receipt could never be attributed with the character of 'royalty'.

Arguments by the Revenue:

- It was pointed out that the assessee engaged the services of VSNL as a provisioning entity for performing certain services in India for which the assessee did not have the license. Thus, the Revenue contended that the receipt is nothing but royalty.
- The assessee provided connectivity to the customer at its premises at both ends of the network and the connectivity is for a dedicated bandwidth capacity for the agreed time. The customer could now monitor the extent and quality of signal transmission at various nodes located all along the network pathway**. The customer thus paid for the use of and the right to use of the equipment.**
- The character of the receipt clearly fits in with **Section 9(1)(vi) read with Explanation 2 (iva)** of the Income Tax Act for equipment royalty; alternatively, it can also be taxed as process, falling under **Explanation 2(iii) to Section 9(1)(vi)** of the Income Tax Act that receipt would nevertheless be held as 'royalty’.
- For tax purpose qua royalty **there need not be a physical or right to use to the user,** he submitted that so long as there is **nexus** between the user, the **situs** of the usage (in India) and the **purpos**e of the use (for offering seamless internet facility), **economic exploitation** of the equipment gives rise to the income to be taxed as 'royalty’.
- **Explanation 5:** points out that for treating a receipt as 'royalty', even possession or control need not be proved
- As network offered is a single continuous unified system, it cannot be bisected as onshore and offshore parts
- **Explanation 6:** payment is also with reference to the use of the process as falling under Explanation 2(iii),
- **That cable is also treated as a commercial equipment.** Thus for the equipment usage and the services utilised, the payment falls within the meaning of 'royalty' and Clause (iva) thus includes licence and lease

- That a right to access and exploit a part of segment of a larger system to use the capacity of the system and the consideration paid therefor clearly falls under **Clause (iva) of Explanation 2 to Section 9(1)(vi) of the ITA** and hence 'royalty'. Even otherwise, it is a right to use a process and a right to use equipment coming within **Explanation 2 to Section 9(1)(vi) of the ITA.**
- Referring to **Article 12 of the DTAA**, he submitted that there is no prohibition therein in assessing royalty in India. As per **Article 3.2 of the DTAA,** the term not defined in the agreement would be understood by the definition contained in the law of the contracting state. Thus, going by the Explanation giving the definition on 'royalty' and 'process', the receipts are rightly taxed herein.
- **Payment by VSNL was only a token payment and hence not the actual consideration for the equipment.** The Revenue pointed out that the equipment is transferred to VSNL by MCI for a token payment of Rs.10,000/-, and the ownership remained only with MCI because VSNL does not have the right to sell the equipment and the equipment is to be handed over at any time to MCI on demand for payment of Rs.10,000/-.
- To avoid tax liability, MCI had split the lease charges for IPLC into two non-existent circuits. **The fact is MCI has provided the composite and indivisible circuit which constituted equipment.**
- The consideration made by the Indian customers is for obtaining an economic interest over the bandwidth under the terms of the agreement. In this, the assessee did not provide any service to its customers but only leased out equipment for use of its Indian customers.
- the assessee provided the Indian customer an **integrated communication system,** part of which is outside India and part of which is inside India for use by the Indian customer and such system **is inseparable and incapable of vivisection** for the purpose of taxation in India
- From all perspective**, the consideration is only equipment royalty**, as IPLC and bandwidth are used by the customer or the right to use the same has been given to the Indian customer by the assessee.

Analysis:

1. <u>THE ARRANGEMENT B/W ASSESSEE AND VSNL ARE RENDERED JOINTLY:</u>

- The agreement entered into between the assessee and the customer herein is for providing of seamless point to point private line so as to enable the customer to communicate between its office that are geographically dispersed.
- The parties had agreed for a particular bandwidth and in entering this the assessee had provided the necessary equipment at customer premises, configured and customised to ensure that the customer gets the uninterrupted connectivity from one end to the other end in different geographical point.
- **The arrangement between the assessee and the VSNL has to be necessarily integrated and technically and financially viable having regard to the close functional relationship between the two.** For this, the Indian customer pays through the single billing system.
- Thus the service agreement assuring the service is possible and workable only when the assessee and VSNL are considered as rendering the service jointly in their respective leg.
- Thus, **the two half being the mirror image of each other** and going by the terms of the agreements**, the assessee renders service in India and the consideration received attracts the incidence of taxation in India.**
- It is no doubt true that the agreement between the assessee and the VSNL states that **one is not the agent or the representative of the other**<u>.</u> This, however, does not mean that VSNL has provided its server independently without any connection whatsoever with the service order that the customer places with the assessee.
- <u>The assessee provides the Indian customer an integrated communication system called IPLC, the part of which outside India is taken care of by the assessee and the part inside India through VSNL, which cannot be dissected as two independent contract having no bearing at all on each other.</u>
- <u>***In the light of the above, the contention of the assessee is rejected.***</u>

2. ASSESSEE COMPANY DOES NOT RENDER MERE SERVICES:

- Bandwidth is defined as the amount of traffic that is allowed to occur between the customer website and the rest of the internet. It is stated that a user having a particular IPLC service connection has a dedicated bandwidth between the computer and the internet provider though the provider itself may have 1000 such service connection to other location. Evidently, service provider has to have enough bandwidth to serve a person's computing needs as well as all of its other customers.
- It is clear from the agreements that the customer is assured of a particular bandwidth; to provide the assured bandwidth, the agreement ensures that the necessary equipment are placed at the customer's end in the Indian half that is compatible with the equipment in the other half outside India, so that the switching facility converts and receives the signal in the network and transmit through the transmission network cable to the ultimate destination.
- Thus, the agreement provides an indefeasible right to the customer to use the facility of communicating the data/voice and has an for providing the required telecommunication services at the assured speed.
- Thus the efficacy of transmitting data/voice depends on the originating signal from the customer end which means **there is the use of the equipment CPE by the customer installed by the assessee.**
- In the circumstances, the argument of the assessee that it merely provided the service to the customer and that the consideration could not be termed as royalty can not be accepted.

3. CONSIDERATION FOR PROCESS:

- **After the insertion of Explanation 5,** possession, control of such right, property or information usage directly by the payer, location of the right are not matters of concern in deciding the character of payment as 'royalty'.
- The customer has a significant economic interest in the assessee's equipment to the extent of the bandwidth hired by the customer. The bandwidth capacity made available on a dedicated basis for the entire contract period**, even if it does not involve a possessory interest, the amount received by the assessee in a way is also for the use of process.**
- **The definition of 'royalty' under DTAA and the Indian Income-tax Act are in *pari materia*.**
- As rightly pointed out by the revenue, ***Explanation 6* defines 'process'** to mean and include transmission by satellite (cable, optic fibre, or by any other similar technology, **whether or not such process is secret.**

HELD: the case of the assessee is rejected

1. After considering the same, with reference to the arguments made by the revenue on the issue of royalty, *vis-a-vis* the agreement terms, it is held that the order of the Tribunal does not call for any interference.
2. ***The Explanations*** inserted thus clearly point out that the traditional concepts relating to control, possession, location on economic activities and geographic rules of source of income recede to the background and are not of any relevance in considering the question under section 9(1)(vi) read with *Explanation 2*.
3. **The receipts were liable to be treated as 'royalty' for the use of IPLC under section 9(1)(vi) read with *Explanation 2(iva)* and correspondingly Article 12(3) of DTAA between India and Singapore.**
4. The Tribunal rightly held that even if the payment was not treated as one for the use of the equipment, the use of the process was provided by the assessee, whereby through the assured bandwidth the customer was guaranteed the transmission of the data and voice.
5. The fact that the bandwidth is shared with others, however, has to be seen in the light of the technology governing the operation of the process and this by itself does not take the assessee out of the scope of royalty.
6. Thus, the consideration being for the use and the right to use of the process, it is ‘royalty’ within the meaning of clause *(iii)* of *Explanation 2* to section 9(1)(vi)

<u>In the circumstances, the order of the Tribunal is upheld by holding that the consideration paid by the customer to the assessee is 'royalty' within the meaning of *Explanation 2(iva)* or in the alternative under *Explanation 2(iii)* of section 9(1)(*vi*) and Article 12(3) of the DTAA between India and Singapore.</u>

Director of Income Tax v. New Skies Satellite BV and M/s Shin Satellite Public Co. Ltd.

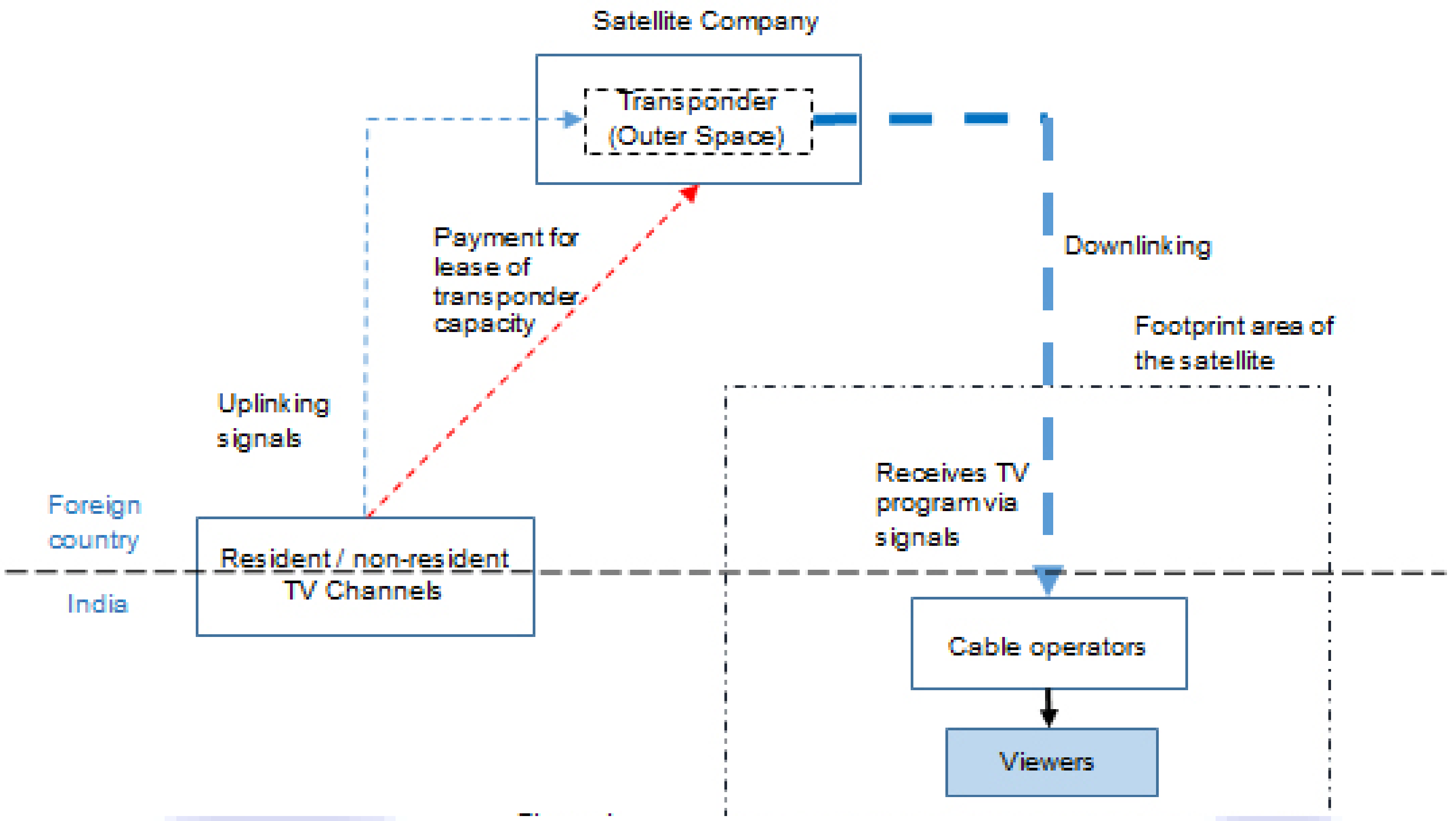
[2016] 238 Taxman 577 (Delhi)

FACTS

- The assessees (foreign companies) are in a business of providing data transmission services in as well as outside India.
  - Derive income from lease of transponder(explained later).
- The Assessment officer included Data Transmission Services as part of income under the head royalty vide Section 9(1)(vi) of the Income Tax Act as well as Article 12 of relevant DTAA.
  - ITAT in appeal overturned the order of A.O. having regard to ratio of Asia Satellite Telecommunications Co. Ltd.
  - Amendment was made to the definition of Royalty, by Finance Act of 2012 by addition of explanations 4,5,6.
  - Post this amendment having retrospective effect, Revenue filed an appeal to the High Court.

- **Grounds of Appeal before the Hon'ble High Court**
  - Whether the receipts of the assessees earned from providing data transmission services, fall within the term royalty under the Income Tax Act, 1961?
  - If the answer to the first is in the affirmative, whether the assessees would be eligible for the benefit under the relevant Double Tax Avoidance Agreements?

PROCESS OF WORKING OF TRANSPONDER



Decision

- **Treaty provisions are not affected by amendments in domestic law**
  - An amendment to the ITA could not be read in a manner so as to extend its operation to a tax treaty, irrespective of whether the amendment was retrospective, prospective or clarificatory.
    - Treaties cannot be unilaterally amended:

      Such treaties(DTAA) are negotiated at a political level based on several considerations, due to which they cannot be amended unilaterally.
    - Bifurcation between terms defined in a tax treaty and terms not defined:

      a.) Terms which are not defined in a tax treaty have to be interpreted in light of its definition under the domestic law. Amendments to the same In such case can be extended to Tax Payers.

      b.) Terms defined in the treaty, to be interpreted in light of the treaty definition alone, and any definition under the domestic law, including amendments thereto, cannot apply.
- **Process must necessarily be "secret process"**
  - In the treaty the word 'process' was followed by comma, so the word 'secret' in "… **, secret formula or process,** …" was read with 'process'.
  - Assumption of careful placement of 'Punctuation marks'.
- Consequently, following the '***Asia Satellite***' case, the Hon'ble Court held that the payment for services would not be 'Royalty'.

SESSION 3- 'INFORMATION' UNDER THE DEFINITION OF 'ROYALTY'

- Explanation 2 to Section 9(1)(vi) defines royalty. However, we will confine our discussion only to clause (iv) of Explanation which defines royalty as consideration for :-

  "(iv) ***the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill"***

- Thus, as per clause (iv) of Explanation 2 to Section 9(1)(vi) payments for any information concerning technical, industrial, commercial or scientific knowledge, experience or skill would amount to royalty under the Act.

ANALYSIS OF SECTION 9(1)(VI)

- The AAR in the case of **Factset Research Systems Inc**., [2009] 317 ITR 169 (AAR), has interpreted clause (iv) of Explanation 2 to Section 9 to clarify that it "*does not contemplate merely imparting information on technical, industrial or commercial matters. The requirement is imparting of information concerning technical, commercial or scientific knowledge, experience or skill.*"

- In the said ruling the AAR held that payments for access to a 'database' which contains publicly available financial data does not amount to royalty under the Act as the 'information' does not relate to the underlying experience or skills which contributed to the end-product.

ANALYSIS OF SECTION 9(1)(VI), CLAUSE (IV) TO EXPLANATION 2

- The same view has also been taken in **Mc Kinsey Knowledge Center India (P.) Ltd. v. ITO** [2018] 92 taxmann.com 226 (ITAT Delhi) and **ITO (Int. Tax.) v. Cadila Healthcare Ltd**. [2017] 77 taxmann.com 309/162 ITD 575 (ITAT-Ahmedabad).
- Thus, evidently, only when an information is a result of experience, skill and expert knowledge of the payee and there is imparting or making available of knowledge, experience or skill, can such information be covered under Section 9.

ROYALTY AS UNDERSTOOD UNDER THE OECD & UN MODEL

- **Article 12 (3) of the OECD Model** defines 'royalty' as 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 **information concerning industrial, commercial or scientific experience.**
- Article 12 (3) of the UN Model Tax convention defining 'royalty' is also similarly worded where 'royalty' has been defined as **information concerning industrial, commercial or scientific experience.**

ANALYSIS OF 'ROYALTY' UNDER OECD & UN MODEL

- Klaus Vogel in his commentary notes that the concerned leg of the definition of 'royalty' designates the payment for ***legally unprotected, not-secret-but-undisclosed knowledge that has been attained through experience*** as 'royalty'.
- Thus, the information need not be 'secret' but undisclosed.

SUMMARY OF CRITERION FOR INFORMATION TO BE ‘TECHNICAL KNOW HOW’

- It must be obtained through experience.
- It is immaterial that third parties might also obtain the same through experience.
- It must have practical application resulting in economic benefit.
- The knowledge should **not be published or otherwise divulged** to the general public or to the professional public.
- General knowledge, expert knowledge or skills that can be obtained by anyone through general or professional literature do not constitute ‘know how’.

SUMMARY OF CRITERION FOR INFORMATION TO BE 'TECHNICAL KNOW HOW'

- For information to amount to know, it must be a result of experience and skills which go beyond pure technical progress and are gained by the payee through their own activities, skills, and innovations.
- Lastly, such information should be more than mere knowledge which the payer can obtain or deduce by himself and should be provided by the payee.

Indian Jurisprudence

- In **Oncology Services India Pvt. vs ADIT,** [2017] 82 taxmann.com 42 (Ahmedabad - Trib), since the payments were for the standard operating procedure developed by the payee over the years with his skill and know-how and the same were made available to the payer to use in rendering of services to its clients and therefore such payments were treated as royalty by the Tribunal.
- However, in **P P.T. McKinsey Indonesia vs. Dy. DIT** [2013] 29 taxmann.com 100 (Mum.-Trib) as the payments were only for mere data which could have been obtained by the payers by their own means, such payments were not treated as royalty as there was no imparting of any technical skill, experience or know-how by the payee.

INDIAN JURISPRUDENCE

- Further, the Bombay High Court in **Diamond Services International P. Ltd. vs. Union of India** [2008] 304 ITR 201 (Bom) had the occasion to observe that the information must be 'imparted'.
- This means that the industrial or commercial experience must be **given, bestowed, communicated, or granted from assignor to the assignee for a consideration.**

DISTINCTION BETWEEN TECHNICAL KNOW HOW AND OTHER CONTRACTS

- Contracts for know-how are different from contracts for provision of services. The following criteria as per the OECD Commentary are relevant for the purpose of making that distinction:
  - Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
  - In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
  - In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material.
  - On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations.

DISTINCTION BETWEEN TECHNICAL KNOW HOW AND OTHER CONTRACTS

The distinction between contract for provisions of services and imparting of know-how is essential to determine the taxability especially when there are different rates in force or a treaty does tax FTS and no withholding obligations apply for payments for such services.

CONCLUSION

- In order to determine the taxability of such payment for information, the nature of information being transferred and whether there is 'imparting' of experience, skill and know through such information, must be verified. Considering the nature of TDS provisions, most assessees follow a conservative approach and deduct TDS by way of abundant caution.
- However, Assessees entering into contracts for information should be careful when defining the deliverables involve so as to avoid conflicts with the department regarding the taxability of consideration under such contracts.

THANK YOU