Bombay Chartered Accountants' Society

Royalties & Fees for Technical Services in International Trade

Presented

by

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Salient Rules of Taxation in Cross-Border Transactions

- Foreign Enterprise (FE) pays tax in its home country.
- FE “may” pay tax in source country.
- Normal Treaty rule of taxing Business income: Country of residence.
- Popular exceptions:
  - → Permanent Establishment (PE) in Source Country.
  - → Royalties; interest; dividend.
  - → Fees for Technical Services (FTS) .

Some Fundamentals.....

- ⇨ Examine scope and implications under the domestic law and under the Treaty
- ⇨ Texts of different treaties may vary; advisable to make specific reference and examine subtle difference.
- ⇨ Anchors of treaty entitlement :
  - Treaty residence.
  - Beneficial ownership.
  - Impact of LOB [E.g.: Dubai, Singapore].
- ⇨ Aggravation impact of Transfer Pricing on: Inadequate or nil payment to AE, PE presence.

Fees for Technical Services

Fees For Technical Services (FTS) : Domestic Law

- ⇨ Normal Rule : Refer Section 9(1)(vii) of Income Tax Act, 1961 which taxes FTS regardless of situs and mode of services
- ⇨ Definition of Fees for Technical Services [Section 9(1)(vii)]: covers consideration for:
  - Managerial Services.
  - Technical Services
  - Consultancy Services.
- ⇨ May overlap in interpretation.

Pre-condition of Service

- ⇨ Thrust is on “Services”.
- ⇨ Distinguish : Product V/S. Services.
  - Created (V/s) Person agrees to create, develop.
  - Anticipated Demand (V/s) work begins after settling specifications.
- ⇨ Distinguish : Equipment hire V/S. service.
- ⇨ Distinguish : Technical service V/s. technology driven service.

Apprehended Confusion…. Service V/s. Underlying IPR

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.

Technical services : Different Facets

Different facets

Part of a sale contract

But Check.
- Service PE applicability.

Rendered outside India; Ishikawajima Harima heavy Industries Ltd. (288 ITR 408)

Protection under Treaty because of:
- Absence of Article.
- Override of IPS Article.
- FIS concept of treaty.
- Impact of MFN.

Source rule exception when payment in respect of business of making or earning of income from source outside India.

Protected under Expl: 2 to 9(1)(vii).

Alternative Treaty Formats

Cont…

Absence of FTS Article

- E.g. Mauritius, Philippines, Saudi Arabia.
- Conveys: no special treatment envisaged for Technical Fees.
- Technical Fees at par with Business Income. Incorrect to treat it as other income.
- FTS Taxable in country of residence if no PE in source country.

Alternative Treaty Formats

Cont…

Concurrent Coverage [Independent Personal Services (IPS)]:

- ⇨ Treaty has Article on Independent Personal Services (- Say, Professional Fees);

  Treaty also has Article on FTS.

- ⇨ Usually, IPS ropes in fixed base : Individuals, Firms.
- ⇨ FE may follow beneficial rule – overriding impact of IPS Article.
- ⇨ Certain treaties specifically avoid the overlap.
- ⇨ Check back source rule in IPS Article. E.g. Brazil

Alternative Treaty Formats

Cont….

Fees for Included Services (FIS) :

- Deals with Technical Services - but, coverage is of FIS. FIS narrower than FTS.
- Under FIS Clause:
  - Service should be technical or consultancy; (plus)
  - Service should satisfy further condition as per the definition viz. should 'make available' technical knowledge, experience, skill, know-how or process. (OR). Consist of development and transfer of a plan or technical design.

Alternative Treaty Formats

Cont….

Impact of MFN Clause:

- ⇨ MFN trigger may be subject to subsequent notification [eg. India Switzerland treaty].
- ⇨ India-France treaty (Protocol applied by judiciary for scope; rate difference recognised by subsequent notificaion).
- ⇨ MFN may restrict FTS to FIS – without consequential service PE trigger.

Procurement of Designs

Design

Standard Design

Customised Design

Designs are products

- Abhishek Developers V/s. ITO [3719–3722/B/04] (Bang).
- Indian Hotels Co. Ltd. V/s. ITO [ITA No. 553/M/2000 (Mum)].

It is technical service

- MRPL V/s. DCIT [ITA no. 1826/Mum/04]
- Gentex Merchants (P) Ltd. V/s. DDIT [94 ITD 211] [Cal]
- TAG report of OECD .
- Suggested changes to the commentary of OECD

Fees for Technical Services (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.			
i. Approved by Government or in accordance with Industrial policy.	10%+s.c.	115A	Gross
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.

Royalties

Royalty Income of FE

- Traditional view:
  - 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?

Inherent Features of IPR Grant

- 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.
- Grantee is permitted to do what otherwise would be infringement.
- Enabled to do what owner could have done.
- Grantee can commercialise the product.

Illustrative Rights of Copyright Holder

- 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.

Apprehended Confusion…. Product V/S. Underlying IPR

Underlying product	**Embedded IPR content**	**What does Licencee of IPR expect?**	**What does Purchaser of product get?**
Medicines / Drugs	Patent	Licence 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 : Explanation 2 To Section 9(1)(vi)

<u>Broad Understanding :</u>

"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 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 : [Explanation 2 to Section 9(1)(vi)]

Contd...

- 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.

Identifying Scope and Exceptions : Section 9(1)(vi)

⇨ 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.

UN Model Definition

Cont…

UN definition dissected

⇨ Consideration for the use of, or the right to use :

a) Copyright of literary, artistic, scientific work.

b) Copyright of cinematograph films.

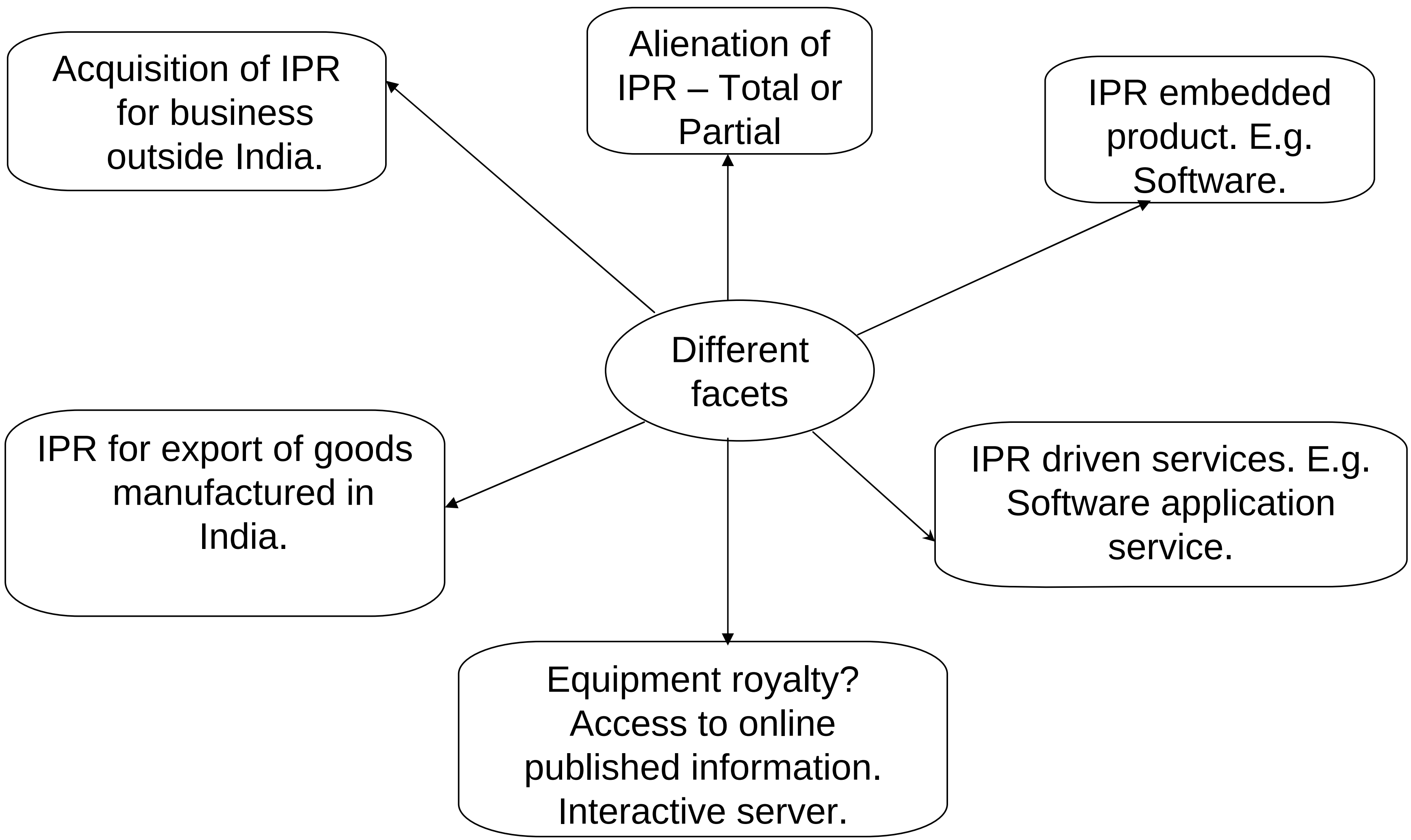
c) Patent, trademark, design, model, plan, secret formula, process.

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.

Royalty : Different Facets



Equipment Hire V/s. Service

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

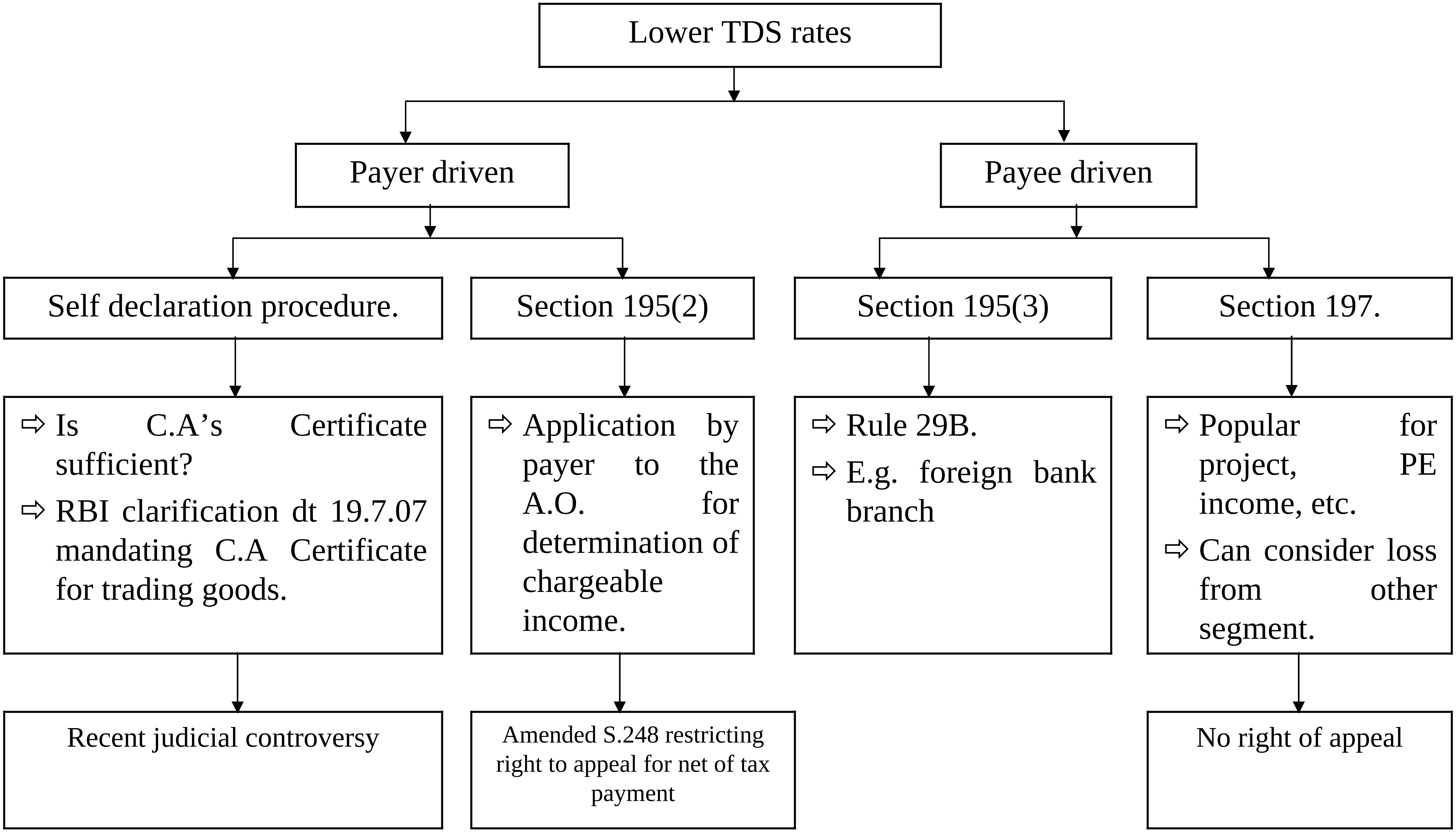
Am I acquiring use of Equipment	**V/s.**	Am I acquiring service of the Equipment

- 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].

TDS Compliance

Radar of TDS Obligation



Thank you….