

Royalty and FTS - Recent Controversies

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Royalty	Fees for Technical Services
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Royalty- Classical meaning

- Phenomenon of “Royalty” has a historical origin. It was equated with the royal prerogative in early centuries.
- It originates from the French words [roialte, or roial]. It was the sense of ‘royal right (especially over minerals)’ which got further developed into the sense of payment made by a mineral producer to the site owner,
- Meaning of “Royalty” further expanded to include payments for the use of patents and published materials.
- **Investopedia Dictionary defines “Royalty” –**
- A royalty is a payment to an owner for the use of property, especially patents, copyrighted works, franchises or natural resources. A royalty payment is made to the legal owner of the property, patent, copyrighted work or franchise by those who wish to make use of it for the purposes of generating revenue or other such desirable activities.

Royalty- Definition u/s 9(1)(vi)

As per Explanation 2 to Section 9(1)(vi)

- 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;

Royalty- Definition u/s 9(1)(vi)

As per Explanation 2 to Section 9(1)(vi)

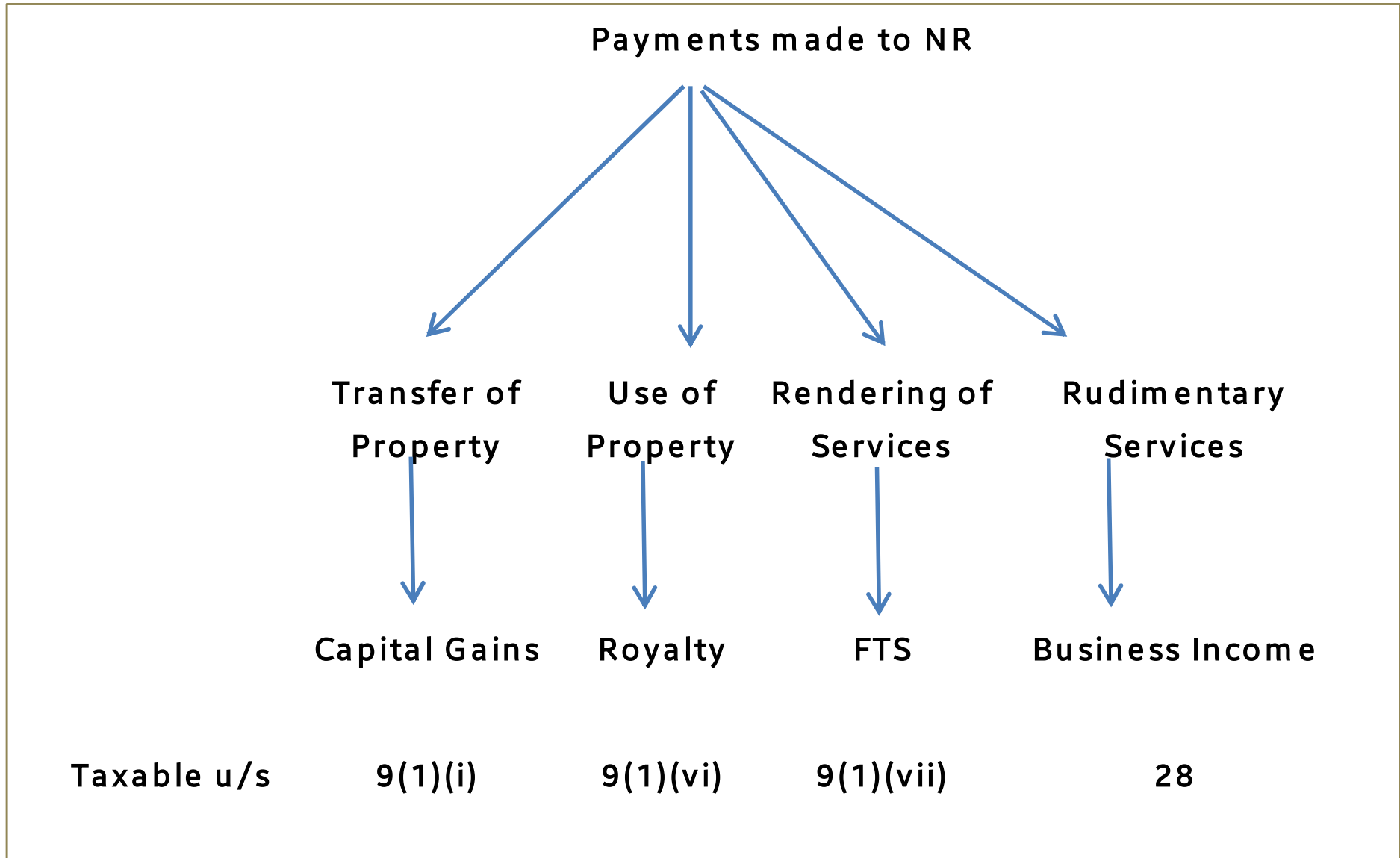
- (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration 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).

Royalty- Definition per OECD

Article-12(2)

- The term Royalties as used in this Article means payment of any kind received as a consideration for the use of or 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.

Characterisation of cross-border income of a NR



Royalty- Analysis of definition u/s 9(1)(vi)

As per Explanation 2 to Section 9(1)(vi)

Royalty - Explanation 2 of Sec. 9(1)(vi)

Families	Patent Family	Knowledge Family	Equipment Family	Copyright Family
<p style="text-align: center;">Actions</p> <p style="text-align: center;">↓</p>				
Transfer of all or any rights in respect of	✓	✗	✗	✓
Imparting Information in respect of	✓	✓	✗	
Use of	✓	✗	✓	
Rendering of any services in connection with above	✓	✓	✓	

Key Issues and controversies

- Payment has to be for use of right, property of information
[9(1)(vi) to be read in a converse manner]
(...mere availability of right, property or information insufficient....Google issue)

- Families of properties in definition u/s 9(1)(vi) denote ownership/ beneficial ownership
 - Non-owner cannot grant rights and if information is extended, it could be a service
(...if such difference rightly read, characterisation changes from Royalty to FTS or vice-versa...e.g. Savis – AHD ITAT)

- Possession/ Domain must for use (especially in equipments)
 - Mere satellite extended = Royalty
 - Satellite capacity extended \neq Royalty
 - (Same for servers, mobile networks, spectrum, etc.)
(...huge misunderstanding – Asia satellite case...and so on....)

Key issues and controversies

- Transfer of full ownership (i.e. alienation) = Capital gain / Business income ≠ Royalty
- Yet, so envisaged u/s 9(1)(vi) ...*(dominance of source rule...and a controversy)*

- Transfer of less than full ownership could also be Capital gain/ business income, if PPT satisfied

Example- Geography right, Sizeable Time Right

- considered as “Royalty” under the Act.....*(dominance o source rule...and a controversy)*

- Royalty and FTS connected to PE, Article-7 / Section 44BB, etc.

(...challenge of grant of cost of Intangibles connected to PE ...including T-P challenge...)

- At every stage, when feasible, one should opt for DTAA beneficial treatment

(...Challenges of sourcing DTAA have become major issues due to local law stipulations...how far it is correct and what can be the fall-out..)

Key issues and controversies

- Imparting Information (Passive Role) ≠ Providing services (Active Role)

(..challenges of differentiation e.g. websites offering compiled data...whether active or passive...Wipro + Gestner decisions hold such instances as "Royalty" as against typical "Service")

- Legal conduit companies could create challenge to source correct DTAA - (Go to beneficial ownership and use such DTAA)*(...tests of a legal conduit company becomes a challenge...)*

- Contractual terms for payment suggest correct character – For Example- Musician in an orchestra)*...non appreciation of such thin differentiation becomes a challenge)*

- Payment for use of developed design is royalty ;but payment for development of design is not royalty*(...again, non appreciation of this difference is a challenge – e.g. R & D services issues)*

- Mixed contracts – PPT, else segregate..*(such splitting becomes a controversy)*

Key issues and controversies

- Addition of Explanation-4 and Explanation-5 have disturbed classical meaning of “Royalty” transpiring from the regular definition and also from OECD model treaty

(...changing very meaning of “Royalty” is a large controversial issue...)

- Whether Explanation-4 has made any real change in position- (Highly debatable)

Payment for use or payment for use of ≠ Payment for transfer of right for use ≠ Payment for transfer of right to use

learned author, Mr. Arvind Datar's commentary says, Explanation-4 has not made any real change...controversy continues)

- All Explanation-5- stipulations against classical meaning

- Possession exists or not
- Directly used by payer or not
- Location in India or not

(...can one say, entire Explanation-5 is misfired...)

Copyright v. Copyrighted product controversy is pending before apex court for last 5-6 years – Copyright Act position is as follows

Right	Section 14(a)	Section 14(b)	Section 14(c)	Section 14(d)	Section 14(e)
	Literary, dramatic or musical work	Computer programme	Artistic work	Cinematograph film	Sound recording
To reproduce	P	P	P	×	×
To issue copies	P	P	P	P	×
To perform work in public/ To communicate to public	P	P	P	P	P
To make film	P	P	P	×	×
To translate	P	P	×	×	×
To make adaption	P	P	P	×	×
To sell or commercially rent	×	P	×	P	P
To sound record	×	×	×	×	P

Royalty- Principles of interpretation

- Noscitur a sociis
- Specific overrides general
- DTAA overrides Income Tax Act
- As per legal mandate, between the ITA and DTAA, more beneficial situation must be resorted to
- Deeming section to be construed strictly
- In overlapping cases, substance to be seen – by applying Principle Purpose Test / Substance over form test...and so on...else, segregation to be done

- (It is felt...finally, it is the first principles which will survive and all in-between controversies will be put to rest)

Fees for Technical Services

Definition u/s 9(1)(vii)

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

(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 :

Fees for Technical Services

Provided that nothing contained in this clause shall apply in relation to any income by way of fees for technical services payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government.

Explanation 1.—For the purposes of the foregoing proviso, an agreement made on or after the 1st day of April, 1976, shall be deemed to have been made before that date if the agreement is made in accordance with proposals approved by the Central Government before that date.

Explanation 2.—For the purposes of this clause, "fees for technical services" means 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".

Fees for Technical Services

Definition under India – USA DTAA

4. For purposes of this Article, "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or 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 paragraph 3 is received ; or

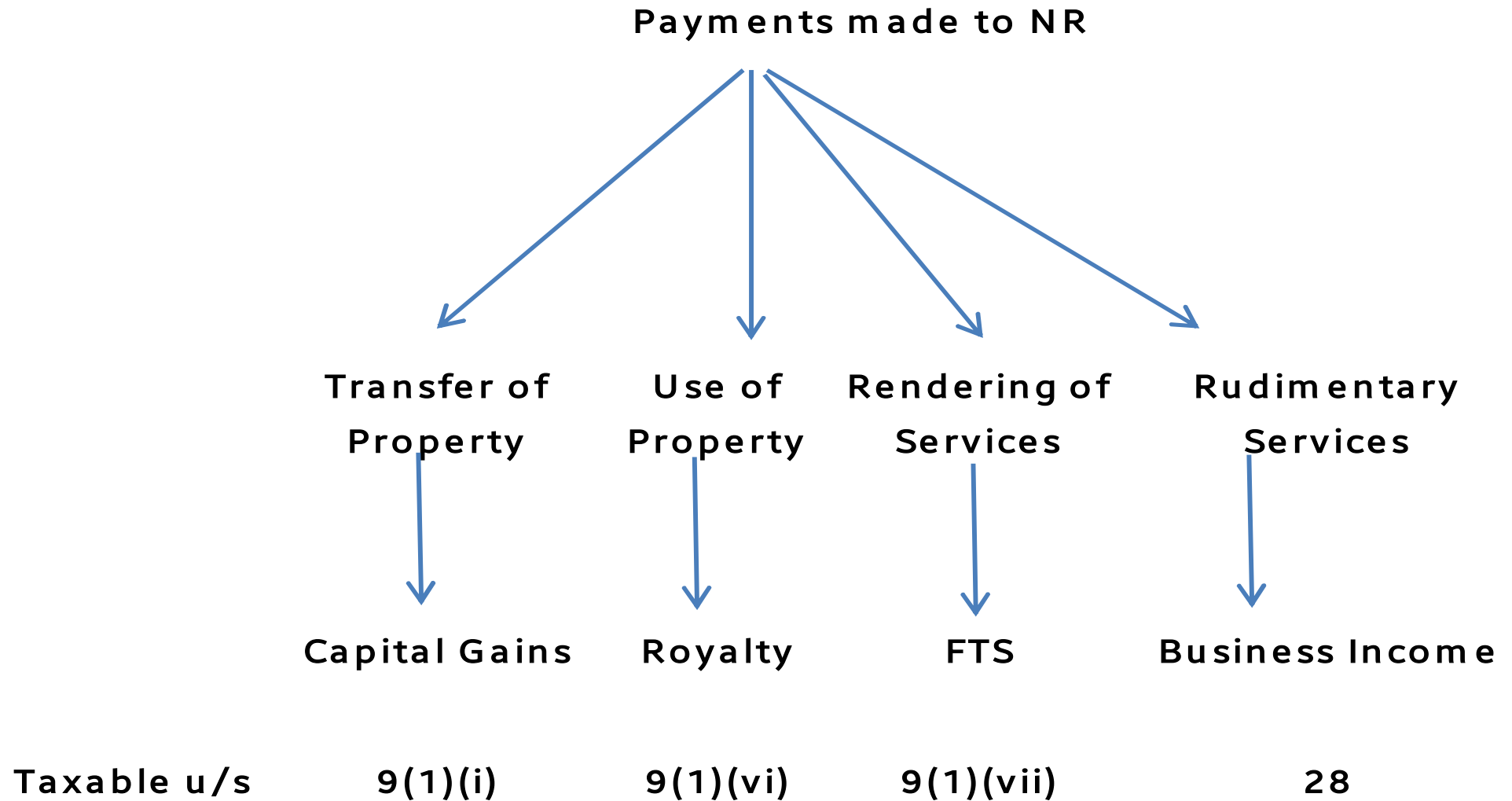
(b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

Fees for Technical Services

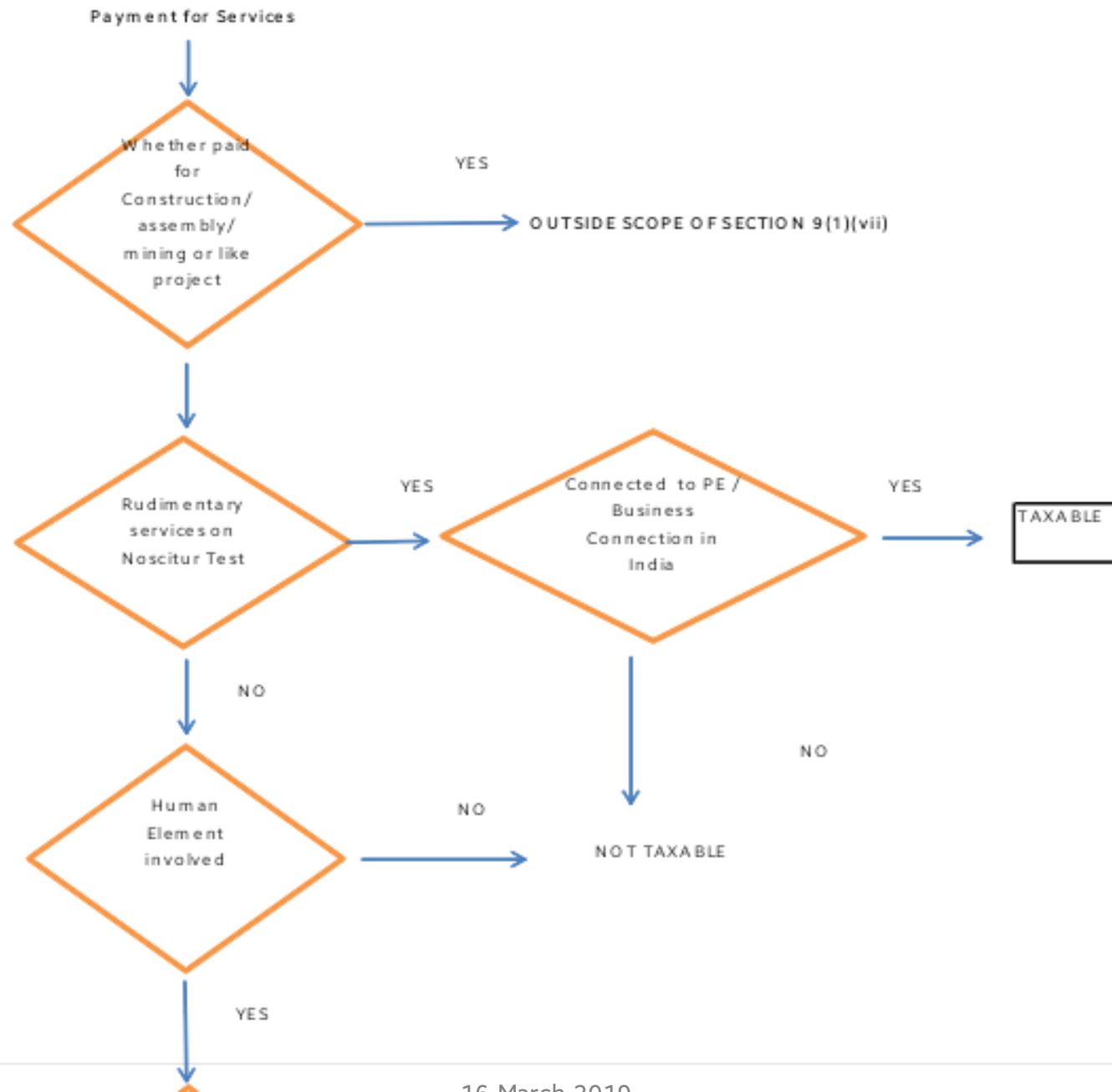
5. Notwithstanding paragraph 4, "fees for included services" does not include amounts paid :
- (a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property other than a sale described in paragraph 3() ;
 - (b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic ;
 - (c) for teaching in or by educational institutions ;
 - (d) for services for the personal use of the individual or individuals making the payments ; or
 - (e) to an employee of the person making the payments or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (Independent Personal Services).

Fees for Technical Services

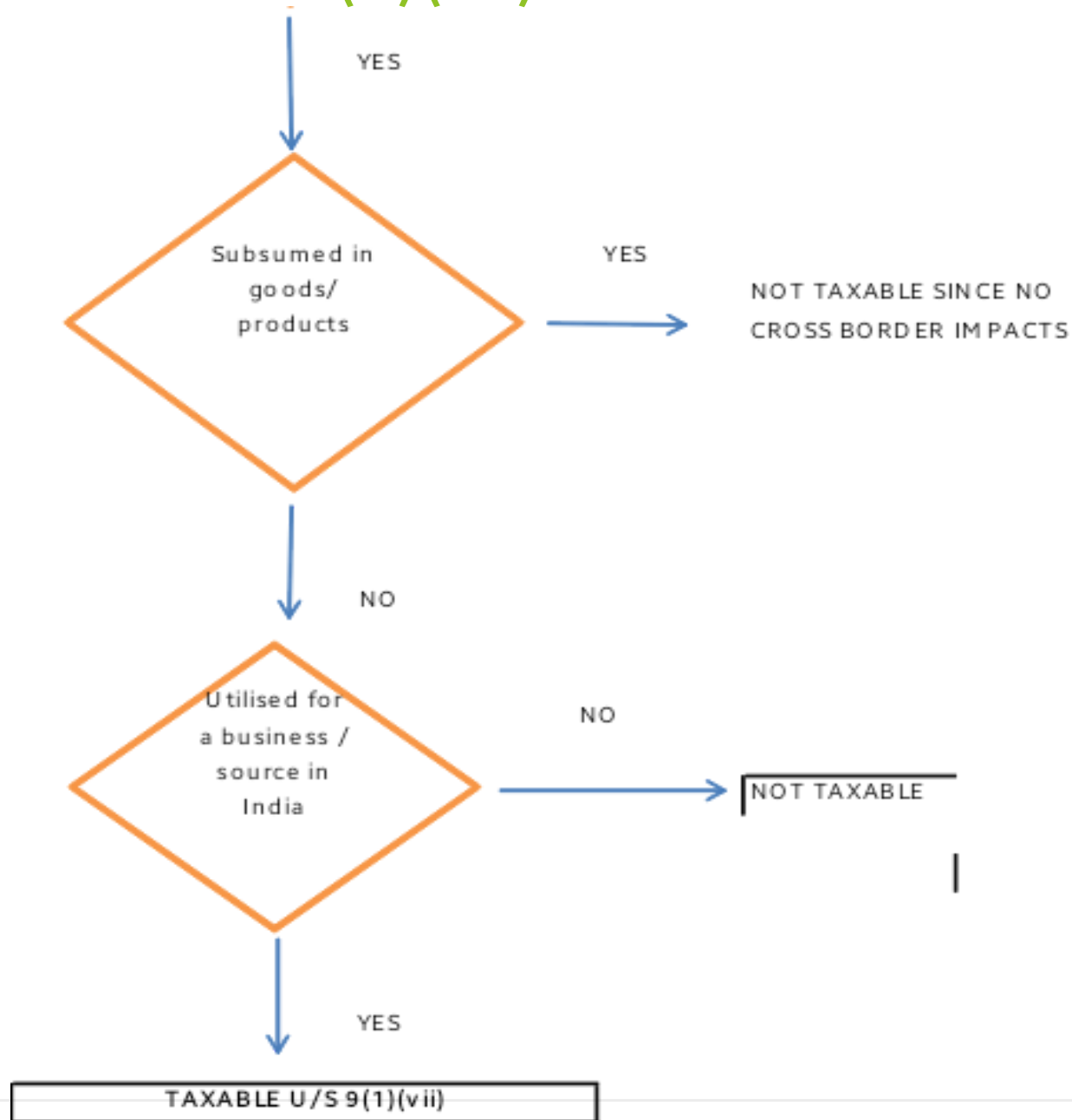
Taxability of services in India



Analysis of Definition u/s 9(1)(vii)



Analysis of Def. u/s 9(1)(vii) – continued



FTS - Key propositions and controversies

- No more any Article in Model OECD Treaty (..hence, all such situations outside FTS deemed taxation, but taxing services is understood as a sovereign right...is this so?)
- Taxing Services on utilization basis is a Source Rule phenomenon (between this conflict, assessee suffers due to double taxation)
- Evolution of business practices has resulted into dissection of activities, which lead to many fold services (..yesterday's SALE becomes SERVICE now ... and so on .. Hence, controversies...)
- Developments like introduction of Equalisation taking place (...Such attempts disturb the classic distribution rule...and pose new challenges of double taxation)

- Literal interpretation of Sec. 9(1)(vii) goes extra- territorial Commentary of Mr. Nani Palkhivala which reads as under

“If the Indian Parliament can cast the net wide enough to collect tax in such cases where the foreigner’s income has no nexus with India, only because the income is derived from a transaction with an Indian, it can equally levy a tax on a hotel in a foreign country where an Indian goes to stay or dine, or on a foreign store where an Indian buys shirts or grocery, or on a foreign physician whose services are sought by an Indian while abroad. Not only are the *cases contrary to the well-settled international norms of taxation of foreigner in*

respect of his income accruing, arising and received outside the taxing state, but they are against the letter and the spirit of the various tax treaties entered into by India with foreign countries, though they do not, and cannot, supersede those treaties (emphasis supplied)

(Challenge is, this aspect is not appreciated by a tax officer...despite the above getting judicial recognition after the GE's case...i.e. nexus / aspect w.r.t. India)

FTS – Key Propositions and controversies

The terms 'managerial', 'technical' and 'consultancy' have not been defined in the Income Tax Act...here is a typical meaning

'Technical services' is a term of wide connotation and includes a range of services involving technical knowledge, assistance in technical operations, maintenance and other support in respect of technical matters. It must be broadly construed to include any kind of service given by someone who is an expert in any subject such that various types of 'professional services' would also be included within the scope.

'Consultancy services' are also technical in nature and advisory services merely involving discussions and advice of routine nature or exchange of information will not amount to consultancy services

'Managerial services' as per the dictionary means 'of or relating to the function or responsibility or activity of management'

(...issue is, yesterday's technical is no more technical today...this timing difference is lost sight of...circular 715 / 716....AMC example)

FTS – Key Propositions and controversies

- Deemed nexus of accrual is confined to elevated services due to Noscitur A Socci
(...despite SC decision, this principle is rarely applied in practice..)
- Scope of FTS gets further restricted due to principle of subsumed services
(...again, not so appreciated...challenges increase if services billing is separate, despite it subsuming..Linde's case...)
- Scope gets also reduced if one applies the twin test of **Render – Utilization**
(...rendition is not same as provision of services...)
(..whether this couples phraseology equates FTS definition to Make-Available)
(...challenges of interpretation / construction though stipulated in ITA..)
- DTAAAs change entire gamut – 3 types of treaties
 - 1st type – Make available clause
 - 2nd type – No FTS clause
 - 3rd type – Clause similar to Sec. 9(1)(vii)
(...if taxation right gets lost, attempts of re-characterization made...challenge)
- Circular 786 clarifying non-taxation of commission Agent acting on foreign soil
(...after withdrawal of the circular, attempts made to tax foreign commission....)
(...though withdrawn, echo of 786 continues ...)

FTS – Key Propositions and controversies

- Difference between technical Services V. Technology Driven Services continues
[...due to modernization of processes, every alternate service is getting modernized ... and technology driven...will Bharati + Kotak rule (non-human involvement) eliminate possible taxation otherwise....]

(How far rationale to make such differentiation....in developing a technology and applying it mechanically, greater human intellect is involved...)
- Finally the Service rendered + utilized in India, ought to be a source of income
*(...case-1 – Engine Production Know-how extended...
...Case-2 – Catalytic Converter methods extended...
....As against, services which perish at once, after their usage ...
...Can such distinction is possible)*
- If services connected to a PE, go for NET profit taxation instead of GROSS consideration taxation
(Claim of connection of services with a PE could also be a challeng....countries have started denying PE based taxation and preferring Consideration Payment taxation – This can result into huge tax losses and double taxation)
- Reimbursement of expenses to NR are typically not taxable in absence of any margin embedded therein*(....how far true...)*

THANK YOU!!!