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Series  
44**



## **ROYALTY AND FEES FOR TECHNICAL SERVICES**

**TAXPAYER INFORMATION SERIES**  
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**TAX PAYERS INFORMATION SERIES 44**

**ROYALTY  
AND  
FEES FOR TECHNICAL  
SERVICES**



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**This publication should not be construed as an exhaustive statement of the Law. In case of doubt, reference should always be made to the relevant provisions of the Income Tax Act, 1961, Income Tax Rules, 1962, Wealth Tax Act, 1957 and Wealth Tax Rules, 1957, and, wherever necessary, to the Notifications issued from time to time.**

## **PREFACE**

Transfer of technology is an important aspect of international trade and investment. Transfer and sharing of intellectual property rights and providing managerial, technical or professional services etc. are important means of such technology transfer. Indian industry and service providers have of late been increasingly entering into agreements with foreign firms so as to access such cutting-edge, technology with a view to upgrade themselves and remain internationally competitive. Though outward flow of royalty payments remain an overwhelming trend in India, inward flow of royalty receipts have also been seen of late. These point to an increasing technological embrace by the Indian industry.

Double Taxation Avoidance Agreements (DTAAs) are primarily an agreement entered into between two countries, with the basic objective is to promote and foster economic trade and investment between the two contracting countries by avoiding double taxation. Taxation of royalties and fees for technical services continues to be an important area of these DTAAs, based primarily on two models- the UN model and the OECD model. But despite DTAAs, disputes often arise due to divergence in the interests between the taxpayers and the tax-collectors. These disputes are also due to the handicap to arrive at a common interpretation of the definition of royalty or technical service, differences between the domestic laws, either common or civil laws characterization of the income classification, forms of underlying contracts etc. Frequent and ever changing technology often presents its own challenges resulting in disputes due to form and multi-dimensional character of intellectual property rights or technical services.

This work by Shri Sanjay Kumar, CIT (IT & CT), CBDT, earlier DIT (Intl. Taxn. & Transfer Pricing), Kolkata and Shri Nilay Baran Som. Dy. Director, DTRTI, Kolkata, is an attempt to bring out some of these underlying issues in a succinct, yet clear, manner.

New and emerging issues on the subject have also been explored and so presented as to make them easy to understand. It is hoped that this book would increase the awareness of the taxpayers on the important issues of royalty and fees for technical service in the field of international taxation and transfer pricing. Keeping in view the objective of the Directorate of Income Tax (PR, PP and OL) to educate taxpayers regarding various issues directly or indirectly related to them. FAQs have also been added on the subject. It is hoped that this publication will prove useful to the readers.

The Directorate of Income Tax (PR, PP and OL) welcomes any suggestion to further improve this publication.

New Delhi

Dated: 19.07.2013



**(R. M. Garg)**

Director of Income Tax (PR, PP & OL)

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## CHAPTER 1

### Introduction

Technology transfer to the developing countries is central to their ability to compete in the global economy and to narrow down the technological gaps they face compared to the developed countries. Technology transfer is a comprehensive term, covering mechanisms for shifting information across borders and its effective diffusion into recipient economies. It ordinarily refers to numerous complex processes, ranging from innovation, marketing of the technology, its absorption and imitation. Included in these processes are trade, and investment policies that can affect the terms of access to knowledge. Successful transfer of technology involving partners from developed and developing countries require financing, as well as home and host country policy measures to stimulate the transfer and local adaptation of technology. Some of the major channels of technology transfer are trade in goods and services, foreign direct investment (FDI), technology licensing etc. In this regard, patents, copyrights, trademarks serve as direct means of information transfer.

#### Modes of Technology Transfer

Normally, three ways are used by the firms to acquire technology. These three modes of transfer of technology are closely interrelated and supportive of each other. The modes or channels are:

- a) **through trade:** international technology transfer through trade occurs when a country imports higher-quality intermediary goods to use in its own production processes;

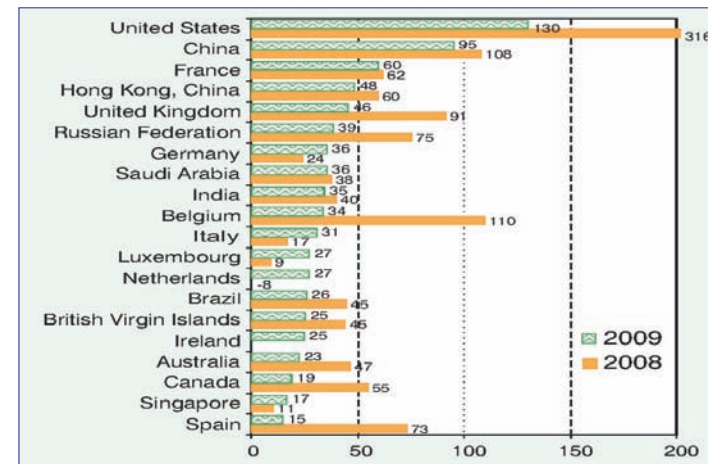
b) **through investment:** a firm can set up a foreign establishment to exploit the technology itself. It can be done by setting up a branch or a subsidiary in the foreign soil. Foreign Direct Investment (FDI) is the most important means of transferring technology to developing countries. Technology transfer through FDI generates more benefits as compared to the other modes of transfer. This is because an investment not only comprises the technology but with it travels the entire management experience and entrepreneurial abilities of the firm. These can be transferred by training programmes and actual work. Further, there are technologies and other know-how used by affiliates of multinational enterprises (MNE) which are not always available in the market, but can be transported only through the MNE itself. Even otherwise, some technologies, even if available in the market, may be more costly to a third party than to the affiliate of the firm itself.

c) **through licences:** sometimes a firm may license its technology to another firm abroad which uses it to upgrade its own production. Licensing sometimes is more desirable than the FDI route. Various tariff and non-tariff barriers, government policies or the general investment climate can make export a costly option. Also, for certain industry sectors, notably in services, trade can be a complicated means to exploit a firm's superior technology or management capabilities overseas. In such cases, a firm who owns a technology may choose to license its technology to a local firm.

**FDI in India**

After economic liberalization, India has been witnessing a thrust in Foreign Direct Investment (Figure 1.1) since the year 1991.

*Figure 1.1: Top 20 FDI Host Countries 2000-09*



*Source: UNCTAD World Investment Report, 2010*

The FDIs for India over a period of time is given in Table 1.1.

**Table 1.1: Inward and Outward FDI of India**

| Years     | Inward FDI       |  | Outward FDI      |  |
|-----------|------------------|--|------------------|--|
|           | In Million US \$ | Percentage of National Gross Capital Formation | In Million US \$ | Percentage of National Gross Capital Formation |
| 1995-2004 | 3 789            | 3.1  | 824              | 0.7  |
| 2005-07   | 17766            | -  | 11 501           | ---  |
| 2008      | 42 546           | 9.7  | 19 397           | 4.4  |
| 2009      | 35 649           | 8.2  | 15 929           | 3.7  |
| 2010      | 24 640           | 4.5  | 14 626           | 2.7  |

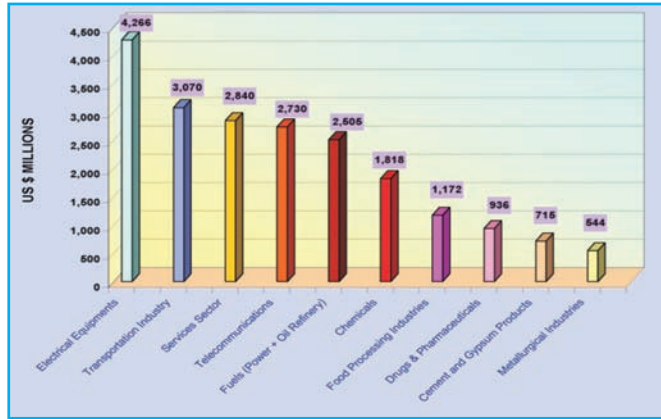
*Source: UNCTAD World Investment Report, 2011.*

UNCTAD Report calculates that India's country ranking improved from to 67 in 2009 from 82 in 2008, but slid to 97 in 2010.

Some of the key recipients (sector-wise) of the FDI are shown in Figure 1.2 below.



**Figure 1.2: India: Sectors attracting Highest FDI Inflows**

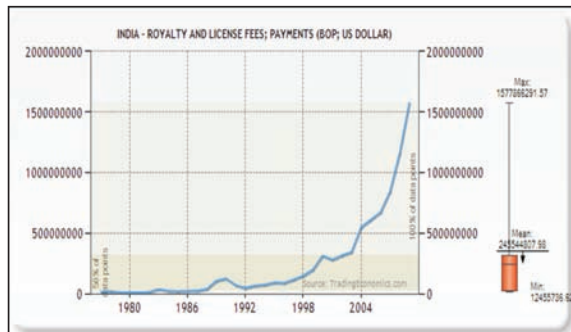


Source: DIPP Website

**Royalty Payments by India**

With the increased FDI, it is expected that Indian firms would be using more and more improved technology for its growing industrial production and services. The increasing use of technology is linked the increased royalty and license fees payments by the business firms. Figure 1.3 below graphically depicts such rise in Royalty payments.

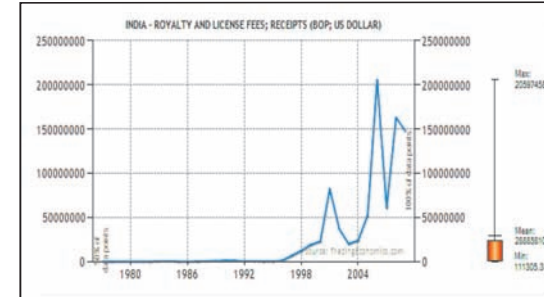
**Figure 1.3: Payment of Royalty & License Fees**



Source: World Bank Website

Another development of the recent times is that India which itself is a recipient of Royalty has been investing in other countries, and so of late there has been some receipt of royalty and license fees by India (Figure 1.4).

**Figure 1.4: Receipt of Royalty & License Fees**



Source: World Bank Website

**What is Royalty?**

Royalty is generally a consideration received by a person - a creator or an innovator for allowing his work of art or scientific invention to be used commercially. But in commercial and industrial terms, the concept of Royalty is wider. Royalty is generally a payment received by the owner of an intangible right or know-how under license in any technology transfer. Such intangible rights are often for making use of intellectual property such as patents, inventions, models, secret formulae, processes, designs, trademarks, service marks, trade names, brand names, franchises, licenses, commercial or industrial know-how, copyrights, cultural activities, films or television rights, literary, artistic or scientific works, computer software, exclusivity rights, etc. Royalty essentially signifies payment for 'user right'. Such user right could be an annual payment or a pre-decided periodical payment.

Royalty has thus embedded in it the concept of rentals received as consideration for use of or the right to use any patent, trademark, design or model, plan, secret formula or process. Payment in the



nature of royalty is quite different from payment in connection with outright sale. In outright sale, along with the property or right over it, the ownership is also transferred. In case of Royalty, the transferor retains the proprietary right in patent, trademark, design or model, plan, secret formula or process, but allows the use of such right etc.

As per the UNCTAD World Development Report 2011, Non-Equity Modes (NEM) of international production is of equal importance as that of Foreign Direct Investment (FDI). NEMs include a range of activities like contract manufacturing, services outsourcing, contract farming, franchising, licensing, management contracts and other types of contractual relationships. Through such relationships, MNCs can significantly influence the management of the enterprises of the host countries without participation in equity. Dissemination of knowledge, technology and skills are essential ingredients of such relationships. Naturally, the enterprises of the host nations will enter into royalty or technical services agreements with the foreign partners, necessitating outgo of licensing or technical services fees. The benefits to the host nations manifest in terms of employment, value added, export generation and acquisition of technical knowhow.

***Box 1.1: What are intellectual property rights?***

The modern industrial society and the present knowledge society have made long strides in the fields of creative art, basic science and technology. The hallmark of such progress and development is invention and innovation. A great deal of research and development activities goes in the medicinal and bio-technological field. Creative work like literary work, music composition, films etc are more technology driven day by day. Even common items like breakfast cereals or clothing, which may not use high end technology, may have high associated commercial value because of brand names, logos or any other creative vehicle for marketing. Computer and telecom products, both in the software and the

hardware category also have the signs of high end technology and creativity.

The inventions and innovations are basically fruits of labour of certain individuals, group of individuals, and/or body corporate. It is natural that the creators and innovators should have their rights well protected for their rights and their fruits of labour should not be allowed to be exploited in unauthorized ways. The creators or innovators should have the right themselves to negotiate payment in return for others using them for whatever purpose. These rights are called “intellectual property rights”. From the above discussion it follows that Intellectual Property Rights or IPRs, as they are commonly called, may take various forms. Books, paintings and films come under copyright; inventions can be patented; brand names and product logos can be registered as trademarks; etc.

**Summary**

Intellectual property rights are the rights given to persons over the creations of their minds. They usually give the creator an exclusive right over the use of his/her creation for a certain period of time. Intellectual property rights are customarily divided into two main areas:

**(i) Copyright and rights related to copyright**

The rights of authors of literary and artistic works (such as books and other writings, musical compositions, paintings, sculpture, computer programs and films) are protected by copyright, for a minimum period of 60 years after the death of the author. Also protected through copyright and related (sometimes referred to as “neighbouring”) rights are the rights of performers (e.g. actors, singers and musicians), producers of phonograms (sound recordings) and broadcasting organizations. The main social purpose of protection of copyright and related rights is to encourage and reward creative work.

## (ii) Industrial property

Industrial property can usefully be divided into two main areas:

- One area can be characterized as the protection of distinctive signs, in particular **trademarks** (which distinguish the goods or services of one undertaking from those of other undertakings) and **geographical indications** (which identify a good as originating in a place where a given characteristic of the good is essentially attributable to its geographical origin). The protection of such distinctive signs aims to stimulate and ensure fair competition and to protect consumers, by enabling them to make informed choices between various goods and services. The protection may last indefinitely, provided the sign in question continues to be distinctive.
- Other types of industrial property are protected primarily to stimulate innovation, design and the creation of technology. In this category fall inventions (protected by **patents**), **industrial designs and trade secrets**.)
- The social purpose is to provide protection for the results of investment in the development of new technology, thus giving the incentive and means to finance research and development activities. A functioning intellectual property regime should also facilitate the transfer of technology in the form of foreign direct investment, joint ventures and licensing. The protection is usually given for a finite term (typically 20 years in the case of patents).

While the basic social objectives of intellectual property protection are as outlined above, it should also be noted that the exclusive rights given are generally subject to a number of limitations and exceptions, aimed at fine-tuning the balance that has to be found between the legitimate interests of right holders and of users.

Reference: [www.wto.org](http://www.wto.org)000

## Box 1.2: IPR Laws in India

### Copyrights and related rights

The Copyright Act, 1957 protects original literary, dramatic, musical and artistic works and cinematograph films and sound recordings from unauthorized use. Copyright is a right given by the law to creators of literary, dramatic, musical and artistic works and producers of cinematograph films and sound recordings. It is a bundle of rights including, inter alia, rights of reproduction, communication to the public, adaptation and translation of the work. There could be slight variations in the composition of the rights depending on the work. Unlike the case with patents, copyright protects the expressions and not the ideas. There is no copyright for an idea but only to the expression of thoughts.

Works covered by copyright include, but are not limited to, literary works such as novels, poems and plays; reference works such as encyclopedias and dictionaries; databases; newspaper articles; films and TV programs; musical compositions; choreography; artistic works such as paintings, drawings, photographs and sculptures; architecture; and advertisements, maps and technical drawings. Copyright also protects computer programs.

The general rule is that a copyright lasts for 60 years. In the case of original literary, dramatic, musical and artistic works the 60-year period is counted from the year following the death of the author. In the case of cinematograph films, sound recordings, photographs, posthumous publications, anonymous and pseudonymous publications, works of government and works of international organizations, the 60-year period is counted from the date of publication.

### **Trademarks**

A trademark is a distinctive sign which identifies certain goods or services as those produced or provided by a specific person or enterprise. It helps consumers identify and purchase a product or service because its nature and quality, indicated by its unique trademark, meets their needs. A trademark is thus a sign that is used to identify certain goods and services as those produced or provided by a specific person or enterprise. Hence, it helps to distinguish those goods and services from similar ones provided by another. For example, “DELL” is a trademark that identifies goods (computers and computer related objects). “CITY BANK” is a trademark that relates to services (banking and financial services).

The Trade Marks Act, 1999 was passed on 30th December 1999 and came into force on 15th September 2003. Before commencement of this Act, the Trade & Merchandise Marks Act governed the protection of trademarks in India, which has now been replaced by the Trade Marks Act. The new Act provides for registration of trademarks for services in addition to goods and has increase the period of registration and renewal from 7 yrs to 10 yrs.

### **Geographical Indications (GI)**

Geographical Indications of Goods are defined as that aspect of intellectual property which refers to the geographical indication referring to a country or to a place situated therein as being the country or place of origin of that product. Typically, such a name conveys an assurance of quality and distinctiveness which is essentially attributable to the fact of its origin in that defined geographical locality, region or country. Under Articles 1 (2) and 10 of the Paris Convention for the Protection of Industrial Property, geographical indications are covered as an element of IPRs.

In India, the Geographical Indications of Goods (Registration and Protection) Act, 1999 came into force with effect from 15th September 2003. This Act seeks to provide for the registration and protection of Geographical Indications relating to goods in India.

### **Industrial Designs (ID)**

Industrial designs are an element of intellectual property. Industrial designs refer to creative activity, which result in the ornamental or aesthetic appearance of a product. The design may consist of three-dimensional features, such as the shape of an article or two-dimensional features, such as patterns, lines or color. Industrial designs are applied to a wide variety of products of industry and handicrafts such as technical and medical instruments, watches, jewellery, house ware, electrical appliances, vehicles, architectural structures, textile designs, leisure goods and other luxury items.

Design rights refer to a novel or original design that is accorded to the proprietor of a validly registered design. But it does not include any mode or principle or construction or anything which is in substance a mere mechanical device. The essential purpose of the Designs Act, 2000 is to promote and protect the design element of industrial production. Under the Designs Act, the designs would not include any trade mark, as defined in the Trade Marks Act or Property mark or artistic works as defined in the Copyright Act.

The duration of the registration of a design is initially for ten years from the date of registration but in cases where, claim to priority has been allowed the duration is ten years from the priority date. This initial period of registration can be extended by a further period of 5 years on an application before the expiry of the said initial period of Copyright.

## **Patents**

A Patent is an exclusive right, which may be for a product or a process, granted by a country to the inventor to make, use, manufacture and market the invention that satisfies the conditions of novelty, innovativeness and usefulness. Examples of patents range from electric lighting (patents held by Edison and Swan) and plastic (patents held by Baekeland), to ballpoint pens (patents held by Biro), microprocessors (patents held by Intel, for example), telephones (patents held by Bell) and CDs (patents held by Russell).

Introduction of Patent Law in India took place in 1856 whereby certain exclusive privileges to the inventors of new inventions were granted for a period of 14 years. Presently, the patent provisions in India are governed by the Patents Act, 1970. The Indian Patents Act is fully compatible with the TRIPS Agreement, following amendments to it; the last amendment being in 2005 by the Patents (Amendment) Act, 2005.

Product patents in the field of pharmaceuticals and agro-chemicals have been introduced by deleting Section 5 of the Patents Act. Those inventions which are considered a mere discovery of a new form of a known substance or mere discovery of a new property or new use will not be considered patentable. A provision for patenting of software that is embedded in hardware has also been introduced in the Patents Act.

The term of every patent is now for 20 years from the date of filing. Provisions for the pre-grant opposition to the grant of patents have also been incorporated in the Act. Earlier such provisions were available only for post-grant opposition.

### **Layout Designs of Integrated Circuits**

The basis for protecting integrated circuit designs (Topographies) is the Washington Treaty on Intellectual Property in Respect of

Integrated Circuits, 1989. India is a signatory to this international agreement. In India, the IPRs on the layout designs of integrated circuits are governed by the Semiconductor Integrated Circuits Layout-Design Act, 2000.

Under this Act, a layout-design shall be considered original if it is the result of its creator's own intellectual efforts and is not commonly known to the creators of layout-designs and manufacturers of semiconductor integrated circuits at the time of its creation. But a layout-design, which is not original, or which has been commercially exploited anywhere in India or in a convention country; or which is not inherently distinctive; or which is not inherently capable of being distinguishable from any other registered layout-design, shall not be registered as a layout-design. But if a layout-design which has been commercially exploited for not more than two years from the date on which an application for its registration has been filed either in India or in a convention country shall be treated as not having been commercially exploited.

The registration of a layout-design shall be only for a period of ten years counted from the date of filing an application for registration or from the date of first commercial exploitation anywhere in India or in any country whichever is earlier. No person shall be entitled to institute any proceeding to prevent or to recover damages for, the infringement of an unregistered layout-design.

### **Protection of undisclosed information**

A Trade Secret or undisclosed information is any information that has been intentionally treated as secret and is capable of commercial application with an economic interest. It protects information that confers a competitive advantage to those who possess such information, provided such information is not readily

available with or discernible by the competitors. They include technical data, internal processes, methodologies, survey methods used by professional pollsters, recipes, a new invention for which a patent application has not yet been filed, list of customers, process of manufacture, techniques, formulae, drawings, training material, source code, etc. Trade Secrets can be used to protect valuable “know how” that gives an enterprise a competitive advantage over its competitors.

There is no specific legislation regulating the protection of trade secrets. India follows common law approach of protection based on contract laws.

## CHAPTER 2

### **Taxation of Royalty and Fees for Technical Services in India-The Legal Framework**

Royalties arise from commercialization of intellectual property rights. Though Royalties and Fees for Technical Services (FTS) are often seen together in tax books as proverbial twins, there are some key differences between the two.

While Royalty is associated with IPR, Fees for technical services are mostly associated with rendering of managerial, technical or consultancy services. The differences are more apparent if we consider what constitutes Royalties or FTS as per Tax Laws. The tax law in India (the Income Tax Act, 1961) contains extensive provisions in respect of taxation of both - Royalty and Fees for Technical Services. These are provided in Section 9 of the Income Tax Act.

#### **What constitutes Royalty as per the I-T Act, 1961?**

Royalty under the Indian Income Tax act, 1961 is defined under Section 9 of the Act. This section provides that consideration flowing in from the following items fall under the category of royalty:

- a) 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;
- b) 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**;

- c) the **use of any patent, invention, model, design, secret formula or process or trade mark or similar property;**
- d) the **imparting of any information** concerning **technical, industrial, commercial or scientific knowledge, experience or skill;**
- e) the **use or right to use** any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;
- f) 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
- g) the **rendering of any services** in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Such payments can be in the form of a regular payment (such as monthly or quarterly) or can be one time lump-sum payment or a combination of the two but such payment even if any lump sum consideration should not be such that it qualifies to be the income chargeable under the head “Capital gains”. This would mean that it should not be a sale or transfer through which the person transferring it revokes its right to use it again.

The I-T Act also excludes the following from the purview of being considered as payment for royalty:

- Consideration for sale, distribution or exhibition of **cinematographic film;** and
- Consideration from the transfer of an IPR, which can qualify to be an income under the head “**income from capital gains**”.

## Amendments in the I-T Act in 2012

In the recent amendments, the scope of royalty income has been clarified. These amendments clarify that with effect from 1 June 1976:

- The payment for a right to use computer software is taxable as a royalty, regardless of the medium through which the software is transferred.
- The payment for use or right to use equipment is taxable as a royalty regardless of whether the payer has possession or control of the equipment, the location of the equipment, or direct usage of the equipment.
- The payment for transmission by satellite, cable, optic fibre or similar technology is to be considered as payment for usage of ‘process’ and is therefore considered taxable as a royalty.

The above amendments though effective from 1 June 1976, the tax authorities can only review the transactions within the overall seven year period as is available in the general framework of the Act.

The clarificatory amendments have broadened the scope of taxation of royalty. The factors of medium, ownership use or right to use and location have been clarified as immaterial in these amendments. The amendments have thus given a new dimension to tax administration in the sphere of royalty taxation. But various benches of ITAT have ruled that the retrospective amendment in the definition of royalty in the Act may not be sufficient to cover cases unless the definition of royalty under various DTAA is changed.

A review of cases of royalty pending before various judicial authorities reveals that the pending cases have large revenue implications and also cover a number of sectors such as broadcasting, satellite transmission, telecasting, software and



information technology, international connectivity service providers, sports bodies, finance companies, telecom operators, medical franchises, etc. Thus, taxation of royalty is an important international taxation issue, in its extent and scope.

### **What constitutes FTS as per the I-T Act, 1961?**

Fees for Technical Services (FTS) have been defined in Section 9 itself under clause (vii) as any consideration (including lump sum) for rendering of any managerial, technical or professional services including the services of technical or other personnel. However, considerations for assembly, mining or similar project undertaken by the recipient have been taken out of the ambit of the definition of FTS. Similarly if any sum is received by a non resident technician is chargeable to tax as salaries, the receipt cannot be taxable as FTS.

Following are not in the nature of FTS:

- Consideration for any construction, assembly, and mining or like project.
- Salary received by a person in connection with providing technical service.

### **Basis of Taxation of Royalty/FTS for non residents**

A number of foreign companies or other non resident entities run their business in India. Their income straightway are accrued or received in India. In some other cases, the income though not straightway accrued or received in India, may be deemed to accrue or deemed to be received in India. Whatever be the case, if the earning of the foreign entity is from royalty or for providing technical services, the payer of such royalty or FTS generally enter into some agreements with the foreign entity. The payer or the user of the royalty or recipient of the technical service, may be the government or any other Indian concern. If the agreement is an eligible one, such income is taxed at a lower, preferential tax rate.

Royalty/FTS for non residents are taxable in India if sourced in India. Apart from payments which are obviously taxable, there are still other situations where royalty/FTS are taken to be taxable, on the premise that is sourced in India. The source rule is summarized in Box 2.1. Since this booklet is essentially concerned with persons who are non residents in accordance with taxation laws in India, a brief look into the relevant law provisions would be appropriate here. These provisions are summarized in Table 2.1.

### ***Box 2.1: Source rule for taxation of Royalty/FTS in India***

#### **Royalty/ FTS income is taxable in India if service is used/ utilized in India. Place of rendering service not relevant**

Section 9(i)(vi)/(vii) of the Act deem royalty/FTS to accrue or arise in India where it is:

- **Payable by the Government**
- **Payable by resident unless** it is payable in respect of any right, property or information used or services **utilized:**
  - for the purpose of or in **the business or profession carried on by such resident outside India** or
  - for the purpose of **making or earning any income** from any **source outside India**
- **Payable by non-resident** only if it is payable in respect of any right, property or information used or services **utilized:**
  - for the purpose of or in **the business or profession carried on by such non-resident in India** or
  - for the purposes of **making or earning any income** from any **source in India.**
- **Effect of the decision of the Hon'ble Supreme Court in the Ishikawajima-Harima Heavy Industries' case vis-a-vis the source rule**



The Decision of the Honourable Supreme Court in the **Ishikawajima-Harima Heavy Industries’ case** (288 ITR 408) gave some direction to the source rule of taxation Royalty and FTS. The salient point of the ruling were

- Offshore services to be regarded as accruing in India
- if **rendered** in India as well as used in India
- There must be **sufficient territorial nexus** to warrant imposition of tax

The above decision gave a jolt to the source rule. To overcome the difficulty,

- **Explanation to section 9 was inserted by Finance Act, 2007 with retrospective effect from 1<sup>st</sup> June 1976.**
- The amendment was to protect the source rule.
- The amended version states that Royalty/FTS deemed to accrue or arise in India shall be included in the total income of a non-resident **whether or not the non-resident has a residence or place of business or business connection in India.**
- **Amendment in definition of FTS by the Finance Act 2010:**

The Finance Act, 2010 has amended the explanation relating to deemed accrual of Royalty and Fees for Technical Services. The pre-amendment explanation provided that in cases of deemed accrual of income of certain kinds including Royalty and FTS , such income is deemed to accrue or arise even if the non - resident does not have any residence or place of business or business connection in India.

The above amendment has further clarified that in respect of FTS, the income shall be deemed to accrue or arise in India

irrespective of the fact that the non - resident might not have rendered any service in India. The amendment has been made in the wake of a few judicial pronouncements regarding FTS. Such judicial decisions held that no income can be deemed in India if service is rendered outside India.

The above tax rules together with the amendments are summarized in the following Table.

**Table 2.1: Summary of Taxability Rules**

| Type of payer          | General Rule  | Remarks  |
|------------------------|---|--|
| <b>Government</b>      | If the payment is of the type covered by the definitions in the Income Tax Act, the payment will be deemed to <b>accrue or arise in India</b> if the payer is Government.   | The I-T Act, 1961 does not define the term Government. Understood in the normal meaning, payments by any Ministry of the Central or State Government is taken to payments by the Government.       |
| <b>Resident person</b> | Generally speaking, Royalty/FTS payable for utilization for the business of such resident in India or for the purpose of earning any income from a source in India, the payment is <b>deemed to accrue or arise in India.</b> | If Royalty/FTS is payable by person for his business outside India or for the purposes of earning any income from any source outside India, such income is not deemed to accrue or arise in India. |

|                              |   |   |
|------------------------------|---|---|
|                              |   | However, if the payment is not under this exceptional category, income will be deemed to accrue or arise in India whether or not the non-resident has any business connection or PE in India. It does not matter whether the service is rendered in India or outside India. |
| <b>Non - Resident person</b> | Royalty/FTS payable for utilization for the business of such Non - Resident in India or for the purpose of earning any income from a source in India, the payment is <b>deemed to accrue or arise in India.</b> | In such cases also, it does not matter whether the non-resident has any business connection or permanent establishment in India or at what place (India or outside) service has been rendered.  |

Depending on whether the foreign entity has some base in India (technically called permanent establishment) and depending on the date of such agreements, the income is taxable either under Section 44D or Section 44DA of the Income Tax Act. The difference between 44D and 44DA like situations is presented in Table 2.2. In cases covered under Section 44D, lower tax rate under Section 115A is applicable for eligible agreements.

**Table 2.1: Summary of Taxability Rules**

| <b>When taxable under Section 44D</b>  | <b>When taxable under Section 44DA</b>  |
|--|---|
| (i) Applicable only for foreign companies  | (i) Applicable for any foreign concern including foreign companies.   |
| (ii) The agreement is in with Government or an Indian concern  | (ii) The agreement is in with Government or an Indian concern   |
| (iii) The foreign company may or may not have permanent establishment in India.  | (iii) The foreign concern must have permanent establishment in India.   |
| (iv) Income is in the nature of Royalty or FTS.  | (iv) Income is in the nature of Royalty or FTS. However, if the non-resident is provider of certain services or facilitates to resident or non resident oil exploration companies or conglomerates, such income is taxable under section 44BB of the Income Tax Act and not under section 44DA.   |
| (v) If the agreement is before 1.4.76, 20% of the gross receipt is allowed as deduction taxable and tax calculated on the balance amount.<br>If the agreement is after 1.4.76 but before 1.4.2003, the total amount is taxable and no deduction is allowed. Tax is however, calculated at lesser rates under section 115A. | (v) The agreement is after the 31st March 2003. The assessee is entitled to get deductions of expenditure incurred for the business. However, the non resident is required to maintain books of account and get the accounts audited as per provisions of the Act. The tax will be computed not as per section 115A but as per rates fixed by the annual finance act. |

The companies/concerns which do not have permanent establishment in India but have taxable royalty/FTS in India through eligible agreements are also taxed at the lower rate as per Section 115A. For eligible agreements entered after 1.6.2005, the tax rate is 10% on the gross amount of such royalties/FTS.

**Box 2.2: Eligible Projects under Section 115A**

Eligible Projects are those which are due to

- (i) Agreement with Government, or
  - (ii) Agreement with an Indian Concern.
- If the agreement is with an Indian Concern, the agreement either has to be approved by the Central Government or the same has to be in accordance with the Industrial Policy of the Government
- Tailpiece:** If the agreement is not an eligible one, then
- For 44D cases in Table 2.2, lower rate will not be available. Tax will be computed in accordance with slab rates as per the Annual Finance Act.
  - For 44DA cases in Table 2.2, same rule applies.

More details on the taxability of royalty and FTS can be seen in Chapter 4. The schematic diagrams below give taxability matrix. Figure 2.1 depicts the law position before 1.4.2003 and agreements prior to that date.

**Figure 2.1: Legal Position before 1.4.2003**

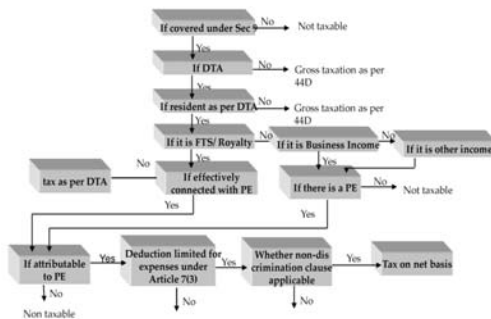
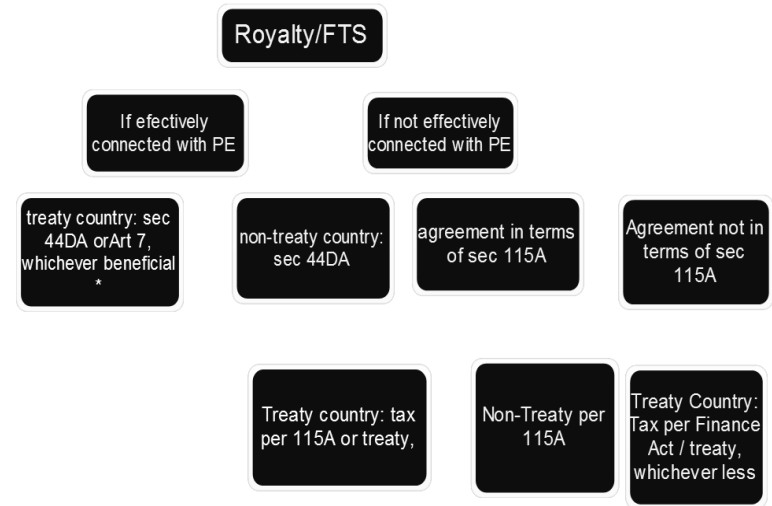


Figure 2.2 below is applicable for the agreements after 1.4.2003.



**Figure 2.2: Legal Position after 1.4.2003**

**Difference between Royalty and FTS**

Basic differences between royalty and FTS can thus be summarized as below:

- a) Royalty is basically for letting of IPRs or for imparting some exclusive information and knowledge. Consideration for services connected with commercial licensing of rights and knowhow are also in the nature of Royalty.
- b) The consideration for the services not connected with royalty may fall in the category of Fees for Technical Services (FTS).
- c) Generally, in the case of Royalty, the owner enables the user to use the technology. In FTS, the owner uses his technology to perform some service for a consideration.
- d) In FTS, the supplier undertakes and guarantees result.

### **Box 2.3 : Residential Status and the Indian Tax Law**

The Income Tax Act, 1961 provides for determination of tax liability of both residents and non-residents. The terms 'residents' and 'non-residents' have meanings as contained in Section 6 of the Act.

For individuals, the residential status is determined on a 'day count' formula as available in Section 6(1) of the Act. An individual is resident in India if

- a) he has been in India for more than 182 days in a previous year relevant to the assessment year, or
- b) his stay in India in that financial year though not more than 182 days, is 60 days or above and his total period of stay in India within the four previous financial years, is 365 days or more.

For companies, however, there is a different set of rules as contained in Section 6(3) of the Act. If a company is an Indian Company (as defined in section 2 (26), of the Income Tax Act), it is resident in India. A company registered under the Companies Act is a typical Indian Company. Some other types of company, such as corporations formed under legislature are another land of Indian Company. Among many other varieties a company other than an Indian Company may also be treated as resident if its control or management is situated in India. In layman's language, companies which are registered abroad under laws of the

foreign state will be non-residents, unless they are controlled from the Indian soil. Therefore, depending on facts, an offshore subsidiary of an Indian Company which is wholly controlled and managed in India may be treated as resident. (Here again a disclaimer: not all subsidiaries have been meant to be wholly controlled and managed in India!) However, branches of foreign

companies are always considered non-residents. For other entities like firms, trusts etc, the same 'control and management' criteria is used [Sec 6(2) of the Act].

The concept of permanent establishment is for non-residents. Commonly understood, permanent establishment refers to a place of business through which a foreign enterprise carries on its business, fully or partly. The definition of permanent establishment typically includes an office, a branch, a factory/workshop, a building or construction site, places of extraction of natural resources (like mines etc) and even a place of management.

### **Role of Tax Treaties in Taxing Royalty/FTS**

The Income Tax Act authorizes the Indian Governments for entering into tax agreements with the other countries of the world for avoiding double taxation of the taxable base. These tax agreements are called Double Taxation Avoidance Agreements (DTAAs). The purpose of such treaties is to set some ground rules so as to avoid double taxation of the same income. The treaties become all the more necessary as every country likes to tax on the basis of **residence principle** (as India has for its residents) or **source principle** (as India has for non-residents).

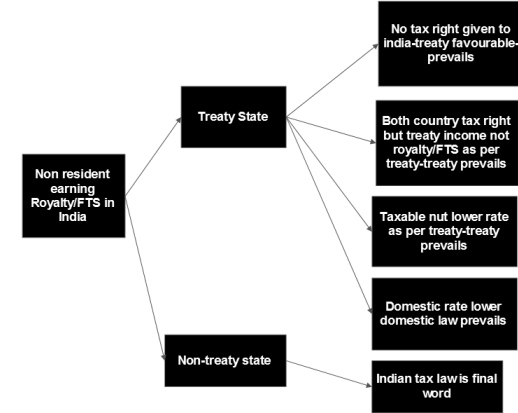
The tax liability as determined under the Act may undergo change by application of the provisions of the treaties. In such a scenario, whichever provision (per the Act or per the Treaty) is beneficial to the non-resident would prevail. Section 9 of the Act provides beneficial position to the non-residents. Table 2.2 provides a summary of the taxability matrix.

**Table 2.2: Matrix of Treaty versus the I-T Act**

The above position is further explained in the schematic representation in Figure 2.3.

| Subject        | Position of I-T Act       | Position Treaty           | Conclusion   |
|----------------|---------------------------|---------------------------|--|
| Item of Income | Taxable as per IT Act     | Not taxable as per Treaty | Not to be taxed, as the treaty provision is beneficial.  |
| Item of Income | Not taxable as per IT Act | Taxable as per Treaty     | Need not go to the treaty provision. If the item is not taxable as per domestic law, the buck stops there! |
| Rate of Tax    | Higher                    | Lower                     | Treaty provision application.  |
| Rate of Tax    | Lower                     | Higher                    | Domestic Law application.  |

The above position is further explained in the schematic representation in Figure 2.3



**Figure 2.3: Treaty versus the I-T Act - Schematic Representation**

**Box 2.6: Treaties - A brief introduction**

Countries across the globe enter into Double Taxation Avoidance Agreements with each other for various socio economic and political reasons. India has entered into double taxation avoidance agreements (also called treaties or conventions) with many countries and limited agreements with respect to income of airlines or merchant shipping. The basis of the treaties, which has a long history is based on the Vienna Protocol which the signing countries honour. The treaties are based on model conventions for avoidance of double taxation. The most prevalent models are the UN Model and the OECD Model

The developing countries mostly follow the UN model which puts a lot of importance on the source country taxation. The OECD model protects the right of developing countries, which, in most of the cases, are the states, of residence for the income earning entities. The US has a model of its own which it uses while entering into negotiation with other countries including India. The treaties India has entered into with other countries are mostly based on the UN or the OECD model.

## CHAPTER 3

### **Royalties and FTS: Model Conventions and the Indian Treaties**

The provisions of the Indian Income Tax Act, 1961 may not be the final determinant for determination of tax liability of a non-resident. This has been explained in the previous Chapter. If the provisions of the Treaty are more favourable to the taxpayer, the same would prevail. It is thus important to know about the provisions of Royalty and FTS in the Tax Treaties and their corresponding provisions in the Model Tax Conventions.

Countries often enter into tax treaties with each other to mitigate the effects of double taxation. Such tax treaties may cover income taxes, inheritance taxes; value added taxes, or other taxes. Most tax treaties:

- define which taxes are covered and who is a resident and eligible for benefits,
- reduce the amounts of tax withheld from interest, dividends, and royalties paid by a resident of one country to residents of the other country,
- limit tax of one country on business income of a resident of the other country to that income from a permanent establishment in the first country,
- define circumstances in which income of individuals resident in one country will be taxed in the other country, including salary, self employment, pension, and other income,

- provide for exemption of certain types of organizations or individuals, and
- provide procedural frameworks for enforcement and dispute resolution.

Besides bilateral tax treaties, multilateral tax conventions are also often used as a guide for framing the tax treaties. In this context, it needs to be understood that tax treaties are normally bilateral as to tax is the sovereign right of a country. Thus, multilateral tax conventions act as guide only.

OECD countries have framed one such convention called, OECD Model Tax Convention on Income and on Capital, with focus on residence of the taxpayer. On the other hand, the UN Model Tax Convention has focus on source of income. Apart from the above, the US Tax Model is often referred to in tax literature.

#### **Royalty Taxation under the two Model Conventions**

The taxation of royalties is an issue that has more to do with the competition between capital-importing and capital-exporting countries in a global economy than it has with substantive legal implications. As a result of the shared taxation envisaged for royalties in many tax treaties, the scope of the definition of royalties varies depending on whether states concerned are considered to be technology-importing or technology-exporting countries. In this respect, countries that import technology and pay royalties are interested in a broad concept of royalties so that they can levy tax on more income at source. Conversely, countries that export technology and receive royalties defend a narrower concept of royalties so that the source country levies less tax on income. Consequently, the residence country would not have to grant relief and would be able to exercise exclusive residence country taxation for this income, as the income would not be royalties subject to shared taxation, but, rather, business profits or independent personal services subject to exclusive taxation in the country of residence.



The two conventions - the OECD and the UN, provide for taxation of royalty income in Article 12. The OECD Convention and the US Model provide for taxation of royalty income in the state where person who beneficially owns the IPR is resident. In the UN Convention, the source (on income) state also has taxation rights, and the resident country may reserve its taxation right. Also, the tax is imposed by the source state at a pre-negotiated percentage of the gross amount. That apart, there are also differences in the definition of royalty itself in the two model tax conventions. It is seen that the OECD convention does not have any clause on equipment royalty, which is available in the UN Convention. Rentals for commercial and scientific equipments fall under the category of equipment royalty.

Since India is traditionally a net importer of technology and hence a payer of Royalty, it has followed the UN Model Convention in its negotiations with most of the countries. A comparison of the taxation of royalty under the two model conventions can be seen in Table 3.1.

**Table 3.1 :Taxation of Royalty in OECD, UN and US Models**

| <b>OECD Model Convention (MC) 2010 : (Extract from Article 12)</b>  | <b>UN Model Convention (MC) 2001: (Extract from Article 12)</b>  |
|---|--|
| <p><b>Definition: Para 12.3</b><br/> <i>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 cinematographic films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.</i></p> | <p><b>Definition: Para 12.3</b><br/> <i>The term “royalties” as used in this Article 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 cinematographic films or films and tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process or for the use</i></p> |

|  |   |
|--|---|
| <p><b>Taxation Right (Para 12.1)</b><br/>           12.1 Royalty arising in a Contracting State and <b>beneficially owned</b> by a resident of the other Contracting State shall be <b>taxable only in that other state.</b></p> | <p><i>of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.</i></p> <p><b>Taxation Right (Para 12.1 &amp; 12.3)</b><br/>           12.1 Royalty arising in a Contracting State and <b>beneficially owned</b> by a resident of the other Contracting State <b>shall be taxable only in that other state.</b></p> <p>12.3 However, <b>such royalties may also be taxed in the Contracting State in which they arise</b> and according to the laws of that State, but if the beneficial owner of royalties is of the other Contracting State, the tax so charged <b>shall not exceed... per cent</b> (the percentage to be established through bilateral negotiations) of the gross amount of royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.</p> |
|--|---|

Thus, the definition of Royalty under the OECD Model is narrower as compared to the UN Model Convention. The US draft treaty on the other hand defines royalty in its Article 12.2 as “(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific or other work (including cinematographic films), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience and (b) gain derived from alienation of any property described in sub paragraph (a), to the extent that



*such gain is contingent on the productivity, use, or disposition of the property.”*

The taxation of royalty is given in Article 12.1 of the US draft treaty, which states, “*Royalty arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other state.*”

### **FTS Taxation under the two Model Conventions**

The OECD Model Convention and the US Draft Treaty do not contain the concept of FTS. It normally forms part of article on ‘business profits’ (Article 7). But most of the treaties which India has entered into provide for source country taxation of FTS. In simple terms, if the source of such income is from India, then the overseas service provider has to suffer Indian withholding tax.

FTS is widely defined to include payments towards technical, managerial and consultancy services. Generally, Royalty and FTS are contained in Article 12 or Article 13 of a tax treaty of India. In some of the treaties, the definition of Royalty may be in line with the UN model, but the definition of FTS may be more restrictive than the definition provided for in the I-T Act, 1961 in treaties with the US, the UK and Singapore. The restrictive nature of the definition is due to the concept of ‘make available’ that is not found in the Indian Tax Law. The UK Treaty is a case in example.

### **“Make Available” Clause**

Article 13 of the UK-India Tax Treaty defines FTS as “*payments for technical or consultancy services which are connected to any payment in the nature of royalty. Another category of services, which ‘make available’ technical knowledge, experience, skill, or knowhow or process, or services that consist of the development and transfer of a technical plan or design also fall into this category.*” Article

12(4)(b) of India-US tax treaty defines FTS to inter alia include “*payments in consideration for the rendering of any technical or consultancy services, which make available technical knowledge, experience, skill, know-how or process.*”

Hence, as per this definition, services result in FTS only if they “make available” technical knowledge, experience etc. Fundamentally, a technology is ‘made available’ when the person acquiring the services. The mere fact that the services have some technical aspects does not mean that technology is made available.

According to the memorandum of understanding (MoU) to the India-US tax treaty, technology is “made available” when the service recipient is enabled to apply the technology. The MoU provides illustrations. For instance, a US resident (X) “makes available” technical knowledge, skill, etc to an Indian resident (Y), when X sends its experts to India to show Y’s engineers how to produce an extra strong wall board, or when X modifies Y’s formulas pertaining to oil refining process, to eliminate cholesterol in refined oil and trains Y’s employees in applying these new formulas.

However, advising on marketing strategies or production on a job work basis are not services which make available technology, skills, etc. This MoU was referred to by the Authority for Advance Rulings in one case (AAR) (242 ITR 208). A US resident company (A) had deputed employees to its Indian group company (B) for rendering services (related to general management, finance, purchase, marketing and assembly/manufacturing activities). B had an irrevocable right to use, disclose and practice without any restrictions, all inventions, ideas and improvements made by A’s employees. The AAR held that such services make available technical knowledge, experience and skills. Not only was there a transfer of information, but B was also conferred the right to use and disclose such technology and knowledge. The Mumbai Tribunal in the case of Raymond Limited v DCIT (86 ITD 791) also referred

to the MoU. The Tribunal held that services rendered by a UK lead manager in managing a GDR issue does not make available any technical knowledge, skill, experience, etc. The Tribunal observed that services could be considered as “making available” technical knowledge, experience, when the recipient is able to make use of the technical knowledge by himself in his own business or for his own benefit and without recourse to the service provider in the future.

There are contrary decisions also. The Delhi Tribunal in the case of ITO v Sinar Mas (85 TTJ 794) held that vetting of an existing project report by a reputed consultant (to enable the service recipient to raise finances) results in FTS under Article 12(4)(b) of India-Singapore tax treaty. However, the Calcutta Tribunal in CESC Limited (80 TTJ 806) held that opining and review of project details per se does not result in FTS under Article 13(4)(c) of India-UK tax treaty. Article 13(4)(c) could be attracted only if suggestions based on technical appraisal, knowledge and skill are ultimately adopted by the service recipient. In rendering its decision the Calcutta Tribunal referred to the MoU to the India-US tax treaty.

Some decisions where services were considered as having been “made available” are Sahara Airlines Ltd v DCIT (83 ITD II) (Del) and Hindalco Industries v ACIT (94 TTJ 944) (Mum). The AAR in a case reported in (100 Taxman 206) also took a similar view. On the other hand, in the case of Airports Authority of India v DIT (273 ITR 437) (AAR) and NQA Quality Systems v DCIT (92 TTJ 946) (Del) it was held that technical knowledge, skills, were not made available by the service provider. A perusal of the judicial precedents indicates that there are some divergence of views. This controversy will subsist only when an authoritative ruling is pronounced.

**Box 3.2: Analysis of Tax Treaties on “Make Available” basis**

| <b>Country</b> | <b>Whether the treaty considers both Royalty and FTS/FIS *(either in a single Article or in two separate Articles)</b> | <b>Whether ‘Make, available clause’ is present in the definition of FTS/FIS</b> |
|----------------|--|---|
| Armenia        | Y  | N   |
| Australia      | Only Royalty   | NA  |
| Bangladesh     | Y  | N   |
| Belarus        | Y  | N   |
| Belgium        | Y  | N   |
| Botswana       | Y  | N   |
| Brazil         | Only Royalty   | NA  |
| Bulgaria       | Y  | N   |
| Canada         | Y  | Y   |
| China          | Y  | N   |
| Cyprus         | Y  | Y   |
| Czech Republic | Y  | N   |
| Denmark        | Y  | N   |
| Finland        | Y  | Y   |
| France         | Y  | N   |
| Germany        | Y  | N   |
| Greece         | Only Royalty   | NA  |
| Hungary        | Y  | N   |
| Iceland        | Y  | N   |
| Indonesia      | Only Royalty   | NA  |
| Ireland        | Y  | N   |
| Israel         | Y  | N   |
| Italy          | Y  | N   |

|                       |              |    |
|-----------------------|--------------|----|
| Japan                 | Y            | N  |
| Jordan                | Y            | N  |
| Kajakstan             | Y            | N  |
| Kenya                 | Only Royalty | NA |
| Korea                 | Y            | N  |
| Kuwait                | Y            | N  |
| Kyrgyz Republic       | Y            | N  |
| Libya                 | Only Royalty | NA |
| Luxemburg             | Y            | N  |
| Malaysia              | Y            | N  |
| Malta                 | Y            | Y  |
| Mauritius             | Only Royalty | NA |
| United Mexican States | Y            | Y  |
| Mongolia              | Y            | N  |
| Montengro             | Y            | Y  |
| Morocco               | Y            | N  |
| Myanmar               | Only Royalty | NA |
| Namibia               | Y            | N  |
| Nepal                 | Only Royalty | N  |
| Netherlands           | Y            | Y  |
| Newzealand            | Y            | N  |
| Norway                | Y            | N  |
| Oman                  | Y            | N  |
| Philippines           | Only Royalty | NA |
| Poland                | Y            | N  |
| Portuguese Republic   | Y            | Y  |

|                     |              |    |
|---------------------|--------------|----|
| Qatar               | Y            | N  |
| Romania             | Y            | N  |
| Russia              | Y            | N  |
| Saudi Arabia        | Only Royalty | NA |
| Serbia              | Only Royalty | NA |
| Singapore           | Y            | Y  |
| Slovenia            | Y            | N  |
| South Africa        | Y            | N  |
| Spain               | Y            | N  |
| Srilanka            | Only Royalty | NA |
| Sudan               | Y            | N  |
| Sweden              | Y            | N  |
| Swiss Confederation | Y            | N  |
| Syria               | Only Royalty | NA |
| Tanzania            | Only Royalty | NA |
| Tazakistan          | Only Royalty | NA |
| Thailand            | Only Royalty | NA |
| Trinidad &          | Y            | N  |
| Tobago              | Y            | N  |
| Turkey              | Y            | N  |
| Turkmenistan        | Y            | N  |
| UAE                 | Only Royalty | NA |
| UAR                 | Only Royalty | NA |
| UK                  | Y            | Y  |
| Uganda              | Y            | N  |
| Ukraine             | Y            | N  |
| USA                 | Y*           | Y  |
| Uzbekistan          | Y            | N  |
| Vietnam             | Y            | N  |
| Zambia              | Y            | N  |

\* The Article 12 of Indo-USA DTAA incorporates 'Fees for Included Services'

### **Fees for Included Services**

This terminology is not found either in I-T Act, 1961 or in the Indian Tax Treaties. The concept first came into being in the treaty with the USA (the term is not present in the US draft treaty). The concept of Fees for Included Services (FIS) is narrower than the concept of FTS. In many other Indian Treaties which have been signed after the US treaty, the terms FIS is not found in letter but the corresponding definition of FTS captures its spirit (UK Treaty, Singapore Treaty, etc).

### **Taxation of Royalty and FTS in other states**

It may be of interest to know how Royalty and ITS are taxed in other parts of the world. For Royalty, the most common rule is the residence of the payer ("**Pay Rule**"). Several countries also regard the source as the State where the intangible property is utilized ("**Use Rule**"). In a few cases, it is the residence of the inventor (Example: **South Africa**), or the place where it is developed (Example: **Argentina**). It may also be the place of the royalty agreement, or where the intangible rights are registered or transferable. The royalties for trademarks and copyrights are usually sourced in the country of registration or the residence of the payer.

'Fees for Technical Services' is generally not defined in the taxation laws of most of the domestic laws of the other states. It may be taxed as business income or independent personal service in the states where the services are rendered.

In most of the countries, Royalty taxed as per "Pay Rule." In some other countries, may be taxed as per "Use Rule." A few country examples are given below:

- **Australia:** In Australia, the source generally depends on the place of the contract and the place where the property is situated. For example, royalties are sourced in Australia if they are paid for conducting a business wholly or partly in Australia.
- **Germany:** Germany does not define royalty separately under the domestic law. Royalty income is classified under the one of the types of income under its tax law, i.e, business income, rental income, independent personal services or other income. Therefore, royalty may be taxed under different source rules. The income from a patent, copyright or know-how of the person is deemed as an income from independent personal services in the hands of the developer or inventor.
- **Japan:** Royalties are domestic-income if a person engaged in a business is in Japan, pays them for his business use in Japan. The Japanese source rules therefore use a mixture of the "use rule" and the "pay rule", with the emphasis on the 'place of use' principle.
- **United States:** The United States has specific source rules for royalties under its domestic law. Royalty income is domestic-source if the property is located within the United States, or if the intangible rights are used in the United States.
- **EC Directive:** The European Commission definition of royalties is contained in the Council Directive 2003/49/EC of 3 June 2003. In this directive, a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States was proposed. Following the OECD Model, the Directive grants an exemption from any taxes imposed on royalties and interests at the source state.

## CHAPTER 4

### **TDS on Royalty from Income of Non-Residents**

We can broadly divide non-resident taxpayers into two categories-(a) those who have regular income in India through some property, business or profession/service in India, and (b) those who have ‘once in a while income in India. In either case, non - residents often are interested to take the income back into their country of residence. This very fact points at the importance of having some mechanism in place for non residents so that the amount of tax chargeable in a transaction is collected, whether or not the amount is remitted out of the country.

In the I-T Act, 1961, the mechanism of deducting tax at source is in place for several types of payments of residents as well for non - residents. The relevant provisions are covered in Chapter XVII of the I-T Act. Obviously, for non-residents, deduction of tax at source is often the most efficient way of collecting tax.

Section 195(1) of the I-T Act lays the ground rules for deduction of tax at source from payments to non residents which constitute income in India (other than salaries). This does not mean that salary earned by a non resident in India is free from deduction at source. Such salary income is also tax deductible at source under Section 192 of the Income Tax Act.

Sec. 195(2) provides that the person “paying any such sum chargeable under this Act...may make an application to the assessing officer” to determine the appropriate proportionate amount on which tax is deductible. Sec. 195(3) enables the non- resident who “may make an application in the prescribed form to the assessing officer” for a certificate. The statute by the use of the word “may” in Sec.

195(2) and (3) providing for Assessing Officer’s certificate in contrast with the use of the word “shall” for deduction itself, where the income is chargeable, does not make an application to the Assessing Officer mandatory. These varied interpretations sometimes raise debates and tax disputes.

One major difference between the TDS for residents and the TDS for non residents under Section 195 is that in the former tax is to be deducted if the amount payable is above a certain base amount. For example, for payments under contract to a resident, tax is deductible only if the payable sum exceeds Rs. 20,000. But in the case of the Non-Residents, all payments, whatever be the source, is taxable under Section 195 of the I-T Act. The tax is to be deducted at time of payment or credit, whichever is earlier. This view was also held by the AAR in the ruling of Flakt India Limited [267 ITR 727]. Another salient feature of Section 195 is that the primary responsibility for ensuring the collection and deposit of the tax due from the non resident is placed on the deductor, and not the non-resident recipients.

#### **Consequence of Non-deduction**


There are several penal consequences for the payer if tax is not deducted at source from the payments to the non-residents. In the assessment of the payer (having business income in India), no deduction can be claimed for such payments as there is specific provision for disallowance under the Income Tax Act (Section 40 (a)(i).) However, deduction can be claimed in a subsequent year. If tax is deducted and paid to the government account is assessment year. Interest and penalty can be levied for such non deduction or late deduction, The payer may also be treated as a representative assessee of the Non - Resident and assessment completed as if the income accrued to him. He will be responsible for payment of taxes out arising out of such assessments. The payer is entitled to recover such amount from the non-resident as per the provisions of the Act. The following table gives a snapshot of the provisions of interest, penalty and prosecution.

**Table 4.1: Snapshot of the provisions of Interest, Penalty and Prosecution**

|   |  |
|---|--|
| <b>Liability to pay the amount which the deductor fails to deduct</b> | If the deductor makes a default in deduction and deposit of the tax deductible and the payee also has not paid tax on such income, <b>such tax may be recovered from the defaulter.</b> This can be done by treating the defaulter as ‘ <b>representative assessee</b> ’ under section 163 of the Act. |
| <b>Interest</b>   | Mandatory interest is to be paid by the deductor from the date on which tax was deductible to the date on which it is paid.  |
| <b>Penalty</b>  | Penalty amount may even be equal to amount of tax deductible. However, if the deductor proves to the satisfaction of the Assessing Officer that there had been sufficient reason for the default, penalty may not be imposed.  |
| <b>Prosecution</b>  | Prosecution may be launched if tax deducted is not deposited to the government account   |
| <b>Expenditure</b>  | Would be disallowed in computing the total income of the deductor in the year of default. However, deduction available in the year in which tax is deducted.   |

### Liability to deduct Tax

The provision for liability to deduct tax under is more debatable and litigated than meets the eye. At first, it is necessary to refer to the text of Section 195 which is reproduced below:



**Sec 195(1):** Any person responsible for paying to a non resident, not being a company, or to a foreign company, any **interest or other sum chargeable under the provisions of this Act** (not being income chargeable under the head ‘Salaries’) shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of cheque or draft or by any other mode, whichever is earlier, deduct income tax thereon at the rates in force\*

\*Means rate of tax as declared by the Finance Act for the year.

From the above text, it is clear that the liability for deduction of tax arises if the interest or other sum (including Royalties and FTS) is chargeable to tax under the Income Tax Act. Courts have held that for the payer to the non resident to deduct tax at source, the interest or other sum should be in the nature of income chargeable to tax. If the interest or other sum is not chargeable to tax (under I-T Act/DTAA), no liability of TDS arises as such. The stipulation appears to be simple enough. However, sometimes the tax authorities and the deductors/non resident recipients are not in agreement whether the interest or other sum is chargeable to tax or not. This divergence in view has led to litigations and various interpretations by the courts. One of the most important rulings in this regard is the Apex Court in the case of the Transmission Corporation of AP (239 ITR 587).

The Andhra Pradesh State Electricity Board, a state owned corporation, made certain payments to non-resident company. The



payments were for purchase of machinery and equipment, and also in consideration of erection and commissioning of the machinery and equipment. The short question involved in the case were that whether the Electricity Board was under an obligation to deduct tax at source from the payment made to the non residents.

The Apex Court in the above case held that the expression 'taxable income' used in Section 195(1) applies to any sum payable to the Non-Resident even if such a sum is a trading receipt in the hands of the payee, if, the whole or part thereof is chargeable to tax under the Act. These provisions are not only limited to the sums which are of 'Pure Income' nature.

One interpretation of the judgement was that TDS is required to be made u/s 195(1) only if the income is chargeable to tax (partly or wholly) under the Act. In cases where the income itself is not chargeable to tax (income does not accrue or arise to the non resident), it was felt the question of making any TDS should not arise.

However, the same judgement has often been interpreted by the Department to mean that whenever there is an obligation to pay to the non residents, the payer has to deduct tax. The Karnataka High Court gave a similar ruling in the Samsung Electronics Case (2009) 185 Taxman 313. In the said ruling,

Interested readers may go through the judgements of the following cases for the purpose of reference:

**Transmission Corporation of AP vs CIT 239 ITR 587 (SC)**  
**CIT vs Samsung Electronics Ltd [2010] 320 ITR 209 (KTK)** (overruled by the GE case)

**GE Technologies Ltd vs CIT (2010) 327 ITR 456 (SC)**

(GE was one of the respondents in the Samsung case)

**Van Ooord Acz India (P) Ltd [2010]189 Taxmann 232 (Delhi)**

the Hon'ble High Court considered it necessary to get such clearance in every case of remittance to a non-resident.

**Prasad Productions Ltd  
125 ITD 263 (Chennai  
Tribunal)**

The Supreme Court, on the other hand, held that any payments made to non-residents will be subject to withholding tax only when such payments are chargeable to tax in India in the case of GE India Technology Centre Private Ltd Vs CIT (2010) 327 ITR 456.

In the GE Technology case, Supreme Court has also brought out the following principles in the matter of section 195 :

- Under section 195(1), the obligation to deduct tax arises only when a sum is chargeable to tax in India.
- Section 195(2) comes into play when the payer does not have any doubt regarding the obligation to deduct tax but is not sure as to the amount on which tax is deducted (this can happen in case of composite payments or cases which have some pure reimbursement components). In such a situation, the person responsible for payment is required to make an application to the Department to determine the proportion on which tax is to be deducted.

In the GE Technology-Samsung case, since the High Court did not decide the issue of taxability of software on merit, the Apex Court remanded the issue to the High Court. Subsequently, the High Court ruled that payment in relation to software is in the nature of royalty. Detailed discussion will be made in Chapter 5 under the topic 'taxability of software payments'.

#### **Procedure for TDS deduction before Remittance**

Payers in India requiring to make remittance to non-residents for reasons, such as import of materials, payment of royalty, sending abroad proceeds of sale of movable or immovable properties in



India, etc, are required to deduct tax and thereafter remit the money, if such amount constitutes income chargeable to tax India. Sometimes it may so happen that the whole of the amount is not chargeable to tax. In case the payer considers the entire amount payable to a non-resident as not the income of the recipient, the payer may apply to the designated officer, ITO/ADIT (TDS, International Taxation) or any other designated officer to determine the appropriate proportion of such sum as chargeable to tax. The CBDT has prescribed format of such undertakings and procedures to be followed by issuing Circulars in this regard.

### **Reserve Bank of India Regulations**

The Reserve Bank of India has stated in its office manual that except in the case of certain personal remittances which have been specifically exempted, no remittance should be made by the banks unless a no objection certificate has been obtained from the Income Tax Department.

### **Forms 15CA and 15CB**

The requirement of obtaining NOC from the Department has recently been relaxed under the liberalized remittance regime. In accordance with the simplified procedure, the remittance can be made through banks or authorized foreign dealers or exchange agents through a procedure popularly known as 'CA Certificate route'. In this procedure, along with an undertaking, a Chartered Accountant will certify whether tax is to be deducted or not from the remittance. As per the prescribed procedure, remittance can be made without any clearance from the department on the basis of an undertaking by the remitter along with a certificate from a Chartered Accountant. The certificate (Form 15 CA) and undertakings (Form 15 CB) are to be submitted (in duplicate) to the Reserve Bank of India/Authorized Dealers who in turn are required to forward a copy to the Assessing Officer concerned. Such CA Certificates (Form 15 CB) are open for further scrutiny by the Department.

### **Electronic Filing of Forms 15CA and 15CB**

The procedure so far was manual. However, due to increase in the volume and frequency of the remittances, the Government has allowed electronic filing of the CA Certificates as this is more convenient to the stakeholders. This is also easier for the Department to monitor and track such remittances on regular basis. The Central Board of Direct Taxes issued a Circular (Circular No. 4 of 2009, dt. 29.6.2009) specifying the new procedure. The Circular has been annexed in Annexure 4.

### **Certificates for determination of taxable portion and certificates for lower deduction and nil deduction**

If the payer feels that tax is not deductible from the sum of remittance, he must file application under Section 195(2) before the Assessing Officer (ITO/ACIT/DCIT, TDS) in the jurisdictional Directorate of International Taxation for an order determining whether this would be the case. The designated Assessing Officer is required to pass a speaking order under Section 195(2) of the Act indicating whether TDS should be deducted or not. There are two alternatives in this respect - 'nil deduction' of tax or 'deduction at a lower rate', under Sections 195(3) and 197 of the Act. A non-resident receiving interest or other sum may apply before the Assessing Officer for grant of a certificate authorizing him to receive such income without deduction of tax. This is popularly known as 'Nil Deduction Certificate' and is provided for in Section 195(3) of the Income Tax Act. There is also provision under Section 197 of the Act to the effect that an assessee whose income is subject to tax deduction at source may apply for lower or nil deduction before the Assessing officer in Form 13. This particular section is applicable for a number of types of income which are tax deductible for resident taxpayers and income of a non resident under Section 195 of the Act.

The forms that have been prescribed under the Income Tax Rules for making application under Section 195 (3) [Form 15C]

specifically mentions a banking company or a person (other than a banking company) who carries on business in India. There is no mention of non - residents having no presence in India through a permanent establishment (PE) in India. In practice however, such non -residents make plane paper application for issue of such certificates. Such certificate is issued only for a limited period counted from the date of issue, generally up to the end of the financial year.

The prescribed form (Form 13) for application under Section 197 does not incorporate any schedule for separately for income tax deductible under Section 195. However, this difficulty is generally resolved by reporting the exact nature of income (interest, technical service etc in the schedule which may be used by a resident taxpayer, and specifically mentioning the residential status of the taxpayer.

#### **Appeal against order under section 195(2): Sec 248**

In cases where the deductor has the liability to deduct tax at source as per agreement with the non-residents, it may so happen that tax had been deducted in pursuance of an order u/s 195(2), though the deductor feels that tax was not deductible. In such cases, the deductor is at liberty to file an appeal against the order u/s 195(2) before the Commissioner (Appeals). It is important that if the deductor does not have liability to deduct tax, no appeal lies under section 248 of the Act, whatever may be opinion of the taxpayer.



#### **Importance of PAN**

The Income Tax Act has inserted Section 206AA with effect from 1.4.2010. It makes it mandatory for the person receiving any income on which tax is deductible to furnish his Permanent Account Number (PAN) to the deductor. Otherwise, tax will be deducted at higher of the following three rates:

- (i) At the rate specified in the relevant provision of this Act; or
- (ii) At the rate or rates in force; or
- (iii) At the rate of twenty per cent.

No certificate under Section 197 shall also be granted unless the application made under that section mentions the Permanent Account Number of the applicant.

The above newly inserted provision prescribes higher rate of tax deduction of tax at source if the payee does not possess a PAN. However, the relevant DTAA provision may prescribe a lesser rate of tax withholding. Many experts have commented that the DTAA provision being more beneficial cannot be denied to the non-resident taxpayer. However, there is an alternative view on this point. It may be noticed that Section 206AA starts with the expression 'notwithstanding anything contained in the Act'. This means that this special provision overrides all other provisions of the Act. All other provisions of the Act include Section 90. That the beneficial provision will apply in case of a conflict between the Treaty and the Act is in accordance with Section 90 only. But the lawmakers have already taken care that Section 206AA overrides all other provision of the Act. Therefore, the payees, if they want to avail the lower of the tax rate (between the normal provision of the domestic Act or the treaty provision), must have a PAN. Otherwise, tax will be deducted as per higher rate as per Section 206AA.

#### **TDS Grossing up Provisions**

Non - Residents often are able to negotiate with the contracting parties to the effect that tax liabilities would be borne by the payer of the Royalty or FTS. The advantage to the Non-Residents in such arrangement is that it is able to receive the amount agreed amount without any deduction. In such a case, the income of the non-resident is grossed up. In other words, tax paid by the deductor on the income dished out is added back to find the true income of

the non-resident. It is provided in Section 195A of the Income Tax Act. This means that the income of the Non - Resident is scaled up by factoring the advantage availed.

#### **Grossing up formula**

**If the TDS rate applicable (as per Domestic Act or the Withholding Tax Rate as per Treaty, whichever is less) is r% the grossed up income of the non resident will be**  
$$A = 100 \times 100 / (100 - r)$$

#### **Exemption from Grossing up**

The grossing up provision scales up the income of the non-residents. However, if certain conditions are satisfied, the tax paid by the deductor is treated as an exempted income of the non-resident so that its tax liability is not increased.

*The conditions are as follows as per Sec 10(6A) of the I-T Act*

- (i) The income of the non -resident is in the nature of Royalty and FTS receivable from Government of India or a foreign concern*
- (ii) The non-resident is a foreign company.*
- (iii) The Royalty and FTS and the corresponding tax is payable by the Government or the Indian concern to the credit of the Central Government.*
- (iv) The agreement is in consonance with the matters included in the Industrial policy of the Government, or if it does, not relate to a matter included in the industrial policy, it is approved by the Government*
- (v) The payment is in connection with an agreement entered into within the period 1.4.76 to 30.6.2002.*

*There are similar provision of income for income other than salary, royalty or FTC for agreements entered into within*

*the same period, if the agreement is between the Central Government and a Foreign Government/ International Organisation and the tax is payable by the Central Government or Indian concern. This is provided in Section 10(6B) of the Act.*

#### **Grant of Refund**

In certain circumstances (for eg, if tax is deducted erroneously or tax deducted and paid for a contract, but the contract itself is cancelled at a subsequent date) tax deducted at source has to be refunded to the deductor. The Board issued two Circulars, viz, Circular No 769 dated 6.8.1998, and Circular No 790 dated 20.4.2000 on these issues. However, the CBDT Circular No 7 of 2007 dated 23/10/2007 has superseded the earlier circulars. The texts of the three Circulars mentioned above are given in the annexures.

#### ***Box 4.1: Administration of Taxation of Non- Resident in India***

***Directorate General of Income Tax (International Taxation) has the responsibility for administration of taxation of non residents. Located at ten cities in India, the Directorates of International Taxation headed by the Director work under the overall control of the Director General. They look after following aspects of non resident taxation:***

- Matters relating to Tax Deduction at Source*
- Assessment of Income*

*In areas where these Directors do not hold jurisdiction, competent authorities assign the matter of tax administration to specific charges.*

*The Director of Income Tax (International Taxation), being equivalent to the rank of the Commissioner of Income Tax, can admit application for revision of an assessment under*

*Section 264 of the Income Tax Act if the relevant conditions are satisfied.*

**Commissioners (Appeals)** are assigned to look into the appellate matters that non residents may file if they are not satisfied with the assessment order passed by officers determining their tax liability. These Appellate Commissioner exercises his power under Section 246 of the Income Tax Act.

If a deductor has the liability to pay the tax for the non resident and he is not in agreement with the order of the authority asking him to deduct and pay tax, he can move an appeal before the commissioner (Appeals). This has been provided for in Section 248 of the Income Tax Act.

#### **Dispute Resolution Panel**

The provision for establishment of Dispute Resolution Panel has been enacted with effect from 1.4.2009. It is a collegiums of three administrative Commissioners formed to resolve the assessment related disputes of foreign companies or matters relating to international transaction between two closely held entities (called Associated Enterprises), relating to transfer pricing cases. The panel has to decide the cases in a time bound manners. Its decision is binding on the department. However, if the taxpayer is not happy with its decision, the issue involved may be further carried to Tribunals and even Courts. The details of powers and the workings of the Dispute Resolution panel is contained in Section 144C of the Income Tax Act.

#### **Authority for advance Ruling**

The Authority had been constituted with effect from 1.6.2003 A non- Resident or a resident (can also be public sector companies) having transactions with non-residents can seek a ruling before the authority in the matter of determination

of tax liability. The Authority decides the issue in a time bound manner so that the non resident can make its investment decisions quickly. The Ruling of the Authority is binding on both the applicant and the Department, unless it is challenged in a writ petition. Decision of the Authority though strictly speaking is applicable to the case of the applicant only for a particular transaction, it certainly has a persuasive value in similar other cases. The provisions regarding Advance Ruling are contained in Chapter XIX-B, Sections 245-N to 245 R of the Income Tax Act.

## CHAPTER 5

### Taxation of Royalty and Fee for Technical Services Issues and Decisions

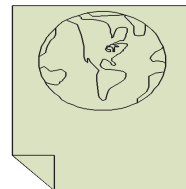
The issues involved in taxation of Royalties /FTS, or for that matter, any type of payment are often not very straightforward, simple ones. In case of international taxation issues, interplay of domestic law and treaty law, and difference in perception between the taxpayer and the tax administrator often leads to litigation. In this chapter, a brief discussion is made on certain selected issues concerning Royalty and FTS. These discussions not a comprehensive or exhaustive one. However, it is of interest to get into the views of the various judicial authorities in India on some debatable issues. Many of the decisions are yet to reach finality in the courts of law. Still, a brief discussion may help in getting an idea about various judicial views and help in drawing up some broad principles.

The issues taken up for discussion in this chapter may be discussed under the following heads:

- Place of accrual of Royalty/FTS
- Meaning of 'Technical', 'Managerial' and 'Consultancy Services' Equipment Royalty
- User charges for server and portal
- Drawing and Design Charges
- Subscription Charges
- Software payments

- Transponder Charges
- Reimbursement of Expenses

The above issues are taken up for discussion one-by-one.



#### Place of accrual of Royalty/FTS

Place of accrual of income is of utmost importance for non resident taxation. This is because for Indian tax laws to be operative, the income should accrue or arise in India or deem to accrue or arise in India. If the income is sourced outside India, Indian tax laws do not operate. The following case laws may be discussed

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#### **Aktiengesellschaft Kuhnle Kopp & Kausch W. Germany By BHEL 262 ITR 513 (MAD) [2003]**

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The Hon'ble High Court held that though royalty was paid by a resident to non-resident, the royalty was paid out of export sales. The origin or the source of the income was outside India, and therefore not taxable in India.

The ruling is basically a reaffirmation of the exclusion of 'deemed royalty' as mentioned in Section 9(1)(vi) of the Act. This particular ruling is on Royalty but the same principle holds good for FTS also.

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#### **Rajiv Mathotra (AAR) 284 ITR 56 [2005]**

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The applicant was engaged in organizing International Food and Wine shows in India. He wanted to appoint agents abroad for marketing and booking space in exhibition. A French Agency was appointed to liaise with Government Agencies, distribution of sales and marketing material and briefing the foreign concerns etc. As



per terms, the French Agency would be paid only after the exhibitors made full payment to the applicant. The applicant came before the Authority with the question whether the commission of the French Agency was taxable in India and in turn, whether the applicant was under obligation to deduct tax at source. In the above facts, the AAR ruled that the source of Income was in India. The rendering of service outside India or the remittance of foreign exchange outside India does not change this basic fact.

### **Meaning of Technical, Managerial and Consultancy Services**

The expression technical, managerial and consultancy services find its place both in the domestic law and in treaties. The US Treaty contains the expression ‘included service’. The taxability of the receipt of a non-resident often depends on its categorization. The categorization itself is often debatable. The concept of ‘make available’ is also important in respect of such services in the context of treaties with certain countries. The following case laws may be discussed.

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#### **Skycell Communications Limited vrs DCIT [251 ITR53]2001(Mad)**

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This decision is in the context of liability to deduct tax at source under Section 194J of the I-T Act. As per this section, entities other than individuals and Hindu Undivided Families (HUF) should deduct tax at source from the fees for technical services payable to any resident. Though this decision is in connection with Section 194J, it is also equally applicable for liability to deduct tax under Section 195 of the Income Tax Act.

“When a person hires a taxi to move from one place to another, he uses a Product of science and technology, viz, an automobile. It can not be on that Ground be said that the railways or the airlines is providing technical service to the person who uses the authomobile....Mere collection of the ‘Fees’ for use of a

standard facility provided to all those willing to pay for it does not amount to the Fees having been received for technical services.”

The facts of this case were that the assessee and a few other entities were in the business of providing cellular mobile services. They were collecting fees from the customers for various kinds of cellular services they had been proving. The department was of the view that the fees received/receivable by the cellular operators are in the nature of fees for technical services and the payers should have deducted tax at source.

The Madras High Court did not concur with this view. The Hon’ble High Court ruled that mere usage of technical equipments does not make a service technical. It was observed that in the instant case, no technical service is offered by the cellular operators.

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#### **CIT vrs Bharti Cellular Limited (Delhi) 330 ITR 239 (SC)**

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Though the issue involved in this case was of domestic taxation but the ruling has implication for international taxation as well. M/s Bharti Cellular Ltd and other appellants are companies engaged in the business of providing cellular telephone facilities to the subscribers. The licenses were obtained from the Department of Telecommunications (DoT). The appellants were to set up their own equipments and infrastructure for operating and maintaining their network. However, if calls are made by their subscribers from their network to other network (MTNL/BSNL/any other private operator), such calls are to be routed through MTNL/BSNL. For the purpose of providing such interconnections, by virtue of agreements regulated by the TRAI, the applicants were to pay interconnection charges, access charges and port charges to MTNL/BSNL.



The Department was of the opinion that the appellants should have deducted tax at source from the connectivity and other charges payable to MTNL/BSNL. The Hon'ble High Court observed that (i) The expression 'Fees for Technical Services' as appearing in Section 194 J is similar to the definition of the term in Section 9(1)(vii) of the Act (ii). The word 'technical' has to be read along with 'managerial' and 'consultancy services'. Both 'managerial' and consultancy services involve some human element. The word technical as appearing in the expression should also have some human element. In the present case, there is no human interface. Therefore, it cannot be said that there is technical service. When the Department went against the ruling of the High Court to the Supreme Court, the Hon'ble Supreme Court remanded the matter back to the Assessing Officer (ITO/AC TDS) to examine, with the help of technical evidence, whether there is any human intervention in the processes involved. Apparently, the view of the courts seems to be aligned to the concept that some human intervention is a must for the service to be 'technical'.

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**G.V.K.Industries & Another vs Commissioner of Income Tax & Another 228 ITR 564(Andhra)[1997]**

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The assessee, an Indian Company, was in the business of generate and sell electricity. It constructed and erected a power generating station. It engaged M/s NRC, a non resident consultancy firm for obtaining advice in the form of preparation of raising finance for the company. The High Court analyzed the facts and the documents involved and came to the conclusion that the income of the assessee cannot be considered as business profits. As per the facts of the case, the services of the Non resident was held to be consultancy and managerial in nature. The assessee maintained that the non resident company only rendered advice in connection with procurement of loans which cannot be termed as technical or consultancy services. The court further held that the advice to strengthen finances is as much a technical or consultancy services

as it would have been any technical or consultancy services with regard to management, generation of power or plant and machinery. The 'success fees' earned by the non resident was categorized as fees for technical services.

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**Intertek Testing Services India (P) Ltd 307 ITR 418(AAR)[2008]**

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The Indian company was engaged in the business of rendering testing and inspection services to its Indian and overseas clients. It entered into agreements with some of its group companies in the field of executive, commercial, financial, marketing and administrative management and technique. The Authority concluded that some of the services are technical /consultancy in nature while some of them are not so. Even in the technical/ consultancy category, a few services are outside the ambit of taxation because the knowledge is not made available to the Indian company. Some of the services, in the views of the Authority, could be managerial in nature.

In addition to the above analysis, the AAR discussed at length the meaning of the term 'technical'. The Authority maintained that the word 'technical' should not be taken in a narrow sense to confine it to matters relating to engineering, manufacturing, etc only. The Authority also held that the consultancy services can be technical as well as non technical in nature.

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**McKinsey & Co Inc vs ADIT 249 ITD 549 (Mumbai)[2006]**

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A number of companies belonging to the Mc Kinsey group rendered certain services to the Indian branch of the US based company. The services were mainly in the nature of information input from the group companies. The department held such services to be in the nature of Fees for Included Services within the India-

US Treaty. The Tribunal held that in the background of the India US Treaty, 'technical knowledge, skill, etc' cannot be said to have been 'made available' to the Indian branch office. The amount was held not to be taxable in India.

The Tribunal also expressed view on what constitutes technical or consultancy services. It was held that such services require some expertise in technology. Consultancy services were held to be advisory in nature which can be technical as well as non technical.

In the instant case, the consultancy services were held to be non technical.

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**Ernst & Young (P) Ltd (AAR No 820 of 2009)**

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The company engaged EMEIA for obtaining strategic consultancy services. EMEIA provided information on various business and commercial aspects, guidelines, best practices and strategies aimed at protection of the image of Ernest & Young and client relations. The Authority held that such services do not make available the technical knowledge and experience.

**Equipment Royalty**

The Finance Act, 2001 introduced the consideration for the use of, or right to use industrial, scientific and commercial equipment in the definition of royalty. The extension of the definition resulted in certain categories of payment to be taxable as royalty. The Indian Tax Authorities have considered charter hire payments and user of portal charges as equipment royalty. There are Tribunal decisions and rulings of the AAR which have upheld such view. However, there are certain treaties which do not cover equipment royalty. This fact has to be remembered carefully. It may so happen that though a certain payment may be in the nature of equipment royalty as per the domestic Act, the relevant treaty definition may not include equipment royalty.

**Charter Hire Payments**

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**West Asia Maritime Limited vs. ITO iii ITD 155 (Chennai ITAT)(2008)**

**Poompuhar Shipping Corporation 282 ITR 39 (Chennai ITAT) (2006)**

**Indian Logistics Limited (SICAL)ITA No.1192/MDS/2004 (Chennai ITAT)**

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Foreign Ships are often hired and used for purposes other than for international traffic. Income of any sort including rentals in the areas of international traffic is governed by domestic law provisions, using presumptive taxation. The treaty provision generally gives the taxation right to the resident country. However, in the above cases, charter hire charges within

Generally, there are two kinds of charter hire -bare boat charter and the time charter. In bare boat charter, only the boat is hired and no crew or provisions are provided. In time charters, boat is hired along with employment of the master and crew.

Indian territorial water have been held by courts to be similar to equipment lease. All the decisions are in the context of Section 195 and it has been held that tax should have been deducted at source at the time of payment to the non residents. Despite the differences between the time charter and bare boat charter, for the purpose of taxation, both types of payments are held to be taxable. Bare boat charter is likened to hire of a car and time charter, hire of the charter with chauffeur. The hire charges, from taxation angle, are again taken to be equipment royalty since ship is held to be equipment. It is also important to note that receipts on account of charter hire charges for movement within the territorial waters of India and not receipts from international shipping can be taxes as equipment royalty. For International Shipping income, there are separate provisions in the domestic Act.

## User charges for Server and Portal

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### **Cargo Community Network 289 ITR 355 (AAR)[2007]**

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The non - resident company based in Singapore hosted a portal and provided access to an air cargo portal. Indian booking agents paid Fees for cargo booking and related services like subscription fee, system connection fees and help desk support fees. Help desk services were provided by the Indian Liaison Office located in India. The payments made by the Cargo Agents in India were in consideration of use of the portal developed by the non resident company and hosted in its server at Singapore. The portal was displayed in the computer screen of the agent in India.

The AAR concluded that server and portal together constitute equipment. The equipment, the Authority observed, was used in India. In the facts of the case, the payment was held as equipment royalty. The AAR in this case also held that the definition of Royalty and Fees for Technical Services in the domestic Act is similar to their definitions in the India Singapore treaty.

### **Drawing and Design Charges**

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#### **CIT vs Davy Ashmore( 190 ITR 626)(Cal ) [1991]**

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An essential precondition for determining royalty is that the non-resident owner of such intellectual property should retain the property while allowing the right to use such intellectual property. In the case of CIT *Vrs* Davy Ashmore India Ltd 190 ITR 626 (Cal), the assessee made payments to a foreign entity in connection with acquisition of certain designs and drawings. These payments were sought to be taxed by the ITO as royalty under Section 9(1)(vi) of the IT Act. The Court rejected the ITO's contention and held that it was a case of outright sale and therefore, the consideration could not be referred to as royalty.

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### **CIT vs Neyvalli Lignite Corporation 243 ITR 459(Mad )[2000]**

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The assessee was engaged in the mining of lignite. It entered into an agreement with a Hungarian Company in connection with its plan for acquisition of Steam Generating Plants. The foreign company was to design, manufacture and supply necessary equipments and material and also supervise the erection, testing and commission of the plant. The consideration for the deliverables was broken up into separate works such as designing, commissioning etc. The Income Tax Officer held the amount relating to drawing and design charges to be royalty, and therefore taxable in India. The ruling of the Court, however, was in favour of the assessee. The Court held that royalty can be deemed to accrue or arise only if the holder of an exclusive right parts with the exclusive right for a consideration and allows the other party to use it. In respect of the current case, the Court observed that mere passing of information concerning design does not itself constitute royalty.

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### **Leonhardt Andra Und Partner GmbH vs CIT249 ITR 418 (Cal) [2001]**

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The assessee, a German company, entered into a design contract with the Hooghly River Bridge Commissioners, Kolkata. The contract was in connection with the design of a bridge over the river Hooghly. The case of the assessee was that it had no permanent establishment in India and so was not chargeable to tax. The assessee also stated that even otherwise, the design contract was an extension of the contract that the company had entered into with the HRBC before 1st April 1976 and so the receipt was not taxable. The Court rejected the contention and held the amount to be taxable. The Court observed the following:

- a) Royalty is not defined in the Indo-German DTAA. One has to go by the domestic law definition. The receipt of the assessee is in the nature of Royalty under the domestic Act.

- b) The agreement for design contract dated 18.4.80 did not indicate that it was an extension of the old agreement. On the other hand, the role of the assessee in the contact had undergone changes with effect from the new date.

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**Gmp International GmbH(AAR)229 CTR 133[2010]**

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In the facts of the case, the assessee was engaged as a consultant for drawing and design services for the new Tamil Nadu Legislative Assembly Building. The consultancy service for supply of drawings and designs to the Government of Tamil Nadu was held to be Fees for Technical Service. The contention of the applicant that the transaction is a transfer of capital asset effected offshore was not found acceptable. The Authorities commented that the mere fact that the sub-contractor was required to perform most of the services connected with the designing of the Complex, and received nearly half of the contact value did not mean that the applicant had not rendered any consultancy services apart from presenting a conceptual architectural design. The Authority also held that ratios of a few other cases including the Davy Ashmore case (supra) are not applicable in this case.

**Subscription Charges**

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**CIT vs HEG Limited [263 ITR230] [MP] 2003**

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In this case, the assessee subscribed to a journal which gave information on a particular industry. The information was commercial in nature. The Department held the view that such subscription charge was in the nature of royalty since the journal was of commercial nature. The High Court held that mere characteristic of being commercial in nature would not make it a thing for which royalty would be payable. Some sort of expertise or skill was required. So, in the absence of such skill in the journal, payments made to it would not be royalty.

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**Wipro Limited vs ITO 278ITR(AT) 57 (Bang)**

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In this case, the assessee had made subscription payments to Gartner Group, an internationally renowned, specialized agency which maintained and published business data pertaining to software technology. In accordance with the agreement, Wipro was to receive access to the database of Gartner which comprised commercial knowledge. The Department sought to tax these under the head 'Royalties' holding that this information came under the head 'commercial experience' in Explanation 2 of Section 9(i)(ii) of the IT Act, Ruling on the question of the information being 'commercial experience,' the Tribunal ruled that the 'experience' mentioned should be one's own experience in the realm of industrial, commercial and scientific, and not compilation of somebody else's experience. Further, such experience should give rise to some form of intellectual property rights. Since, the facts compiled were not the compilation of Gartner's experience, and the compilation too did not warrant copyright protection, the claims of the assessee were upheld. Therefore, from the analysis done on the cases above we can come to the conclusion that for payments made to a non-resident to be considered as royalty, the payments should be like rentals, with ownership remaining in the non resident; the consideration received should be something which is an intellectual property under any of the applicable acts like the Copyright Act, 1957, the Trade Marks Act, 1999, or the Patents Act, 1970 or know how and there should be transfer of 'copyright right' to modify or commercially exploit the property.

**Provision of services for Oil and Gas industry**

Many non-resident companies are engaged in the oil or natural gas exploration business. Other Non - Resident entities may provide services to them. Whether such services will be covered by Section 44BB or will be taxable as Fees for Technical Services



will depend on the facts of the case and the contents of the agreements. It is important to note that in cases that where

- i) the service provider is a non resident and it provides service to another non resident oil exploration company;
- ii) the service is in the nature of fees for technical services
  - a) for agreements prior to 1.4.2003, FTS will not be taxable under section 44D or 115A since the payer is neither government nor an Indian concern (it is non resident). The tax rate will be as per Finance Act or as per Treaty, whichever is less.
  - b) for agreements after 1.4.2003, for concerns having no Permanent Establishment in India, tax will not be computed under section 115A but tax rate as per the Finance Act should apply, since the payer is neither government nor Indian concern (it is non resident ). The tax rate will be as per Finance Act or as per Treaty, whichever is less.
  - c) for agreements after 1.4.2003, for concerns which have Permanent Establishment In India, business profit will be computed in accordance with Section 44DA.

Many questions have been raised whether all the services provided to the oil or mineral exploration enterprises should be taxable under section 44D/44DA or section 44BB of the Act. In many cases courts have held that since Section 44BB is a special section concerned with taxation of oil exploration companies, Section 44D/44DA will have no applicability. The Finance Act, 2010 amended both Sections 44DA and 44BB. The present law position is that for oil and mineral exploration companies, if the service is technical in nature, presumptive taxation under Section 44BB will not apply.

In the context of Section 44BB, the following decisions are important: Halliburton Offshore Services Inc [2008] 300 ITR 265 - It was held that presumptive profit is applicable on the gross receipts and not the income element. The Delhi ITAT decision in the case of Sedco Forex International Drilling Inc vrs Dy CIT 72 ITD 415 has also been reversed by the High Court in 214 CTR 192 (Uttarakhand)(2008)

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### **Geofriyaka Torun Sp Zo [2010] 186 Taxmann 213**

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The applicant was a marine geophysical company which conducted seismic data survey and provides offshore seismic data acquisition and other associated services to oil companies. The question before the AAR was whether the applicant was assessable under Section 44BB or Section 9(1)(vi) read with Section 44DA.

The AAR held that Section 44BB is a special provision for all concerns providing all kinds of services to oil companies. The Authority did not agree with the view of the Revenue that Section 44BB is applicable to services other than Technical Services. However, from assessment year 2011-12, the legal provision is as per the amended version of the Act, as described above.

### **Computer Software**

Many taxpayers located in India (including branch of non resident companies) are required to make payments to non resident companies for software charges. Some taxation issues are involved in such transactions. It will be useful to discuss some related concepts and terms associated with computer software.



#### **5.1: What is Computer Software?**

The phrase '**Computer Software**' has not been defined in the Income Tax Act. However, it finds a place in Section 9 of the Income Tax Act. It runs as follows: *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.*

**Computer software**, or just software, is normally a collection of computer programs and related data that provide instructions to a computer, what to do and how to do it. In other words, software is a conceptual entity which is a set of computer programs, procedures, and associated documentation concerned with the operation of a data processing system. We can also say that software refers to one or more computer programs and data held in the storage of the computer for some purposes. In other words, software is a set of programs, procedures, algorithms and its documentation. Program software performs the function of the program it implements, either by directly providing instructions to the computer hardware or by serving as input to another piece of software. The term was coined to contrast to the old term hardware (meaning physical devices). In contrast to hardware, software is intangible, meaning it “cannot be touched” Sometimes the term includes data that has not traditionally been associated with computers, such as film, tapes, and records.

*Reference: Wikipedia.*

Payment for transfer of computer software is one of the most litigated issues under the Indian Income Tax laws. Payments to a Non resident can be in the form of business income, capital gains or royalties on the basis of facts and interpretations of law. Many times, the taxpayers tend to consider payment for transfer of computer software as business income, and in the absence of a Permanent Establishment to be outside the ambit of taxation. Tax Authorities, on the other hand, consider such payments as royalty. The principles found in the tax literature and judicial rulings are summarized below:

- a) The consideration for right to use the copyright in the software can be royalty or business income, depending on the terms of the contract whether the property in goods passed to the user or not. If it is outright sale, the payment would be business income in the hands of the non-resident (seller of the software). If the user has no ownership and only the right to use, the payment to the non-resident would be royalty. Variations in contracts or terms of sale can however complicate such distinction.
- b) Some of the Court decisions as well as commentators also make distinction whether (a) license fees is for customized software (made for suiting specific requirement of the user) or (b) off-the-shelf software. Some of the courts hold the consideration for off-the-shelf software (Standard, commercial as not royalty)
- c) Distinction has also been seen in terms of whether the payer of license fees acquires the right to use the software alone or has the right to make copies and distribute it to the public. It is also

#### **OECD on Taxation of Software**

OECD recognizes taxing right of the resident country, i.e, there is no taxing right for the source country. The OECD commentary specifically deals with the issue of software, recognizing the complexity of the issue.

If transferor retains the ownership right but allows the payee to reproduce and distribute the software to the public or to modify and publicly display the program, consideration of such type would be in the nature of royalty. If such permission is only limited in extent, the payment is not considered royalty.

Any consideration which involves complete transfer of ownership, such transaction would be taxable as business profits or capital gains. The



important to consider whether the right of distribution is with or without rights of modification of the software. Many taxpayers rely on the Supreme Court Decision in the case of Tata Consultancy Services *v/s* State of Andhra Pradesh (271 ITR 401) in the case related to AP Sales Tax. In the said ruling, software was declared as 'goods'. On the basis of such observation, it is held that payments for procurement of goods cannot be royalty. It may however, be stated that the Supreme Court Decision was in the context of sales tax act.

business income of the non resident will taxable in the source country if the foreign enterprise has a Permanent Establishment (PE). Sometimes the transferee obtains rights to make multiple copies of the program for operation only within the enterprise. A payment under such arrangement is to be taxed as business profits.

Sometimes distributors make payment to the copyright holder to enable it to distribute copies of the program without right to reproduce the program. Consideration accruing to the owner would again be business profits.

Transactions where a software house or a computer programmer agrees to supply information and ideas of the principles behind a particular program would be taxed as royalty.

Thus we see that meaning of terms does vary as per the contexts and terms and conditions of the agreements are important for such determining context.

The issue continues to be debated. A brief description of few decisions of the judiciary is given below in the following order:

- a) **Decisions in favour of the taxpayers**
  - b) **Decisions in favour of revenue**
- Decisions in favour of assessee

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**Samsung Electronics Co Ltd vs ITO 93 TTJ 658  
[2005](Tribunal Decision)**

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Korea based company was engaged in the business of development, manufacture and export of software to be used by its parent organization. The assessee imported software from the USA and France. No tax was deducted at source from the payments made to the foreign companies. The Income Tax Officer was of the view that the payment constituted income in the nature of royalty in the hands of the foreign entities and tax should have been deducted. While the Commissioner (Appeals) upheld this view, the ITAT ruled otherwise. The ITAT analyzed the provisions of the respective DTAA's and ruled that acquiring software is like acquiring a product where copyright is embedded, without any right to exploit the copyright. Such an acquisition, in the views of the Tribunal, cannot be said to constitute use or right to use the copyright of the copyrighted article.

*In the ruling of the High Court the issue of taxability was not discussed as such. The High Court confined itself to the provision of section 195 and ruled that tax should have been deducted at source since payment has been made to a non resident. The view of the High Court has been reversed in the ruling of the Supreme Court in the (referred to as the GE Technology case) on the interpretation of section 195. The Supreme Court reverted to case back to the High Court. To decide on the issue of taxability on merits. In the recent decision, [2011] 16 taxmann.com, the High Court has characterized such payment as royalty.*

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**Lucent Technologies Hindustan Limited [2005] 92  
ITD (Bangalore)**

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The assessee in this case imported software along with hardware. The Assessing Officer was of the view that the assessee

had defaulted as it did not deduct income tax at source. The ITAT analyzed the facts of the case and came to the conclusion that:

- a) the transaction was for purchase of an integrated equipment (hardware and software);
- b) acquisition of the software was in separable from acquirement of the hardware; and so
- c) such payment was not in the nature of royalty

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**Sonata Software Ltd vs ITO(International Taxation)  
6SOT700(Bangalore)[2006]**

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In this case, the company imported some packaged software. Under the agreement with the supplier, the company distributed the packed software to the ultimate user. The Assessing Officer held such payment as royalty. The Commissioner (Appeals) confirmed the view of the Assessing Officer. On appeal, the Tribunal referred to the following:

- a) Where the transaction is acquisition of a shrink-wrapped software or off-the-shelf software, the transaction is one of purchase of goods and not payment of royalties.
- b) The payment in the instant case was for purchase of a copyrighted article and not to acquire any copyright.
- c) The receipt of the non resident is in the nature of business income
- d) The payee does not have a Permanent Establishment in India and hence no business income accrues or arises in India.

The Tribunal also held that provisions of Section 195 are not applicable in this case.

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**Motorola Inc, Ericson Radio System AB & Nokia  
Corporation vs DCIT [96 TTJ 1 ITAT (SB) Delhi] [2005]**

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The Special Bench of the Delhi Income Tax Appellate Tribunal was constituted to adjudicate upon various tax issues in connection with transactions of foreign companies with the Indian cellular companies. Some of the Indian Companies were their own subsidiaries, direct or indirect. Among various tax issues, the Special Bench examined whether the payments in relation to software made to the foreign companies should be assessed as royalties. The Hon'ble Tribunal, after examining the provisions of the contracts, domestic law provisions and the DTAA concluded the following:

- in all the three cases, the payments for software cannot be separated from the payment on account of hardware;
- the payments were on consideration of copyrighted articles and not copyrights as such; and so
- such payments cannot be taxed as royalty.

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**Dassault Systems 3221TR 125 (AAR)[2010]**

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The applicant in this case was Japanese Company. It provided '*Products lifecycle management*' software solutions and services. In its business model, it enters into agreements with resellers and their product were sold to the reseller at a listed price. The reseller sold the product to the end user at a price independently determined by it. The reseller procured order from the reseller and in turn placed an order with the applicant. After accepting the order, the applicant sent a licence key through email so that the customer could directly downloads it though the internet. There was also an End User License Agreement (EULA) put in place which incorporated all business and usage conditions.

The applicant before the Authority contended that the receipts accruing to it is in the nature of business profits. It was stated that in the absence of permanent establishment, it does not have any tax liability in India. It was also argued that the receipt cannot be

categorized as royalty. In the opinion of the applicant, what is transferred to the end user is that copyrighted software containing computer program but not the copyright concerned. The revenue, on the other hand, maintained the stand that the consideration is royalty.

The Authority ruled in favour of the applicant. It was mentioned that passing on a right to use and facilitating the use a product for which the owner has a copyright is not the same as transferring the right. The Authority also observed that although the expression 'license' has been used, no exclusive license is transferred in this case. Accordingly, the sum was held not to be taxable as royalty. The Authority also mentioned that the point whether the receipt can be categorized as FTS was not raised by either of the litigating parties.

#### **Decisions in favour of revenue**

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#### **Microsoft Corporation vrs ADIT (1TA Nos 1331-1336 of ITAT) Delhi)[2010]**

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Microsoft Corporation, USA created a complex distribution channel involving US and singapore based entities for distribution of 'shrink wrapped software'. The entities denied tax liabilities in India on various grounds, such as, that sale of copyrighted products is not royalty but business profits; that such business profits cannot be taxable as there is no PE. In the views of the Assessing Officer, the end users required a further license even after acquiring the software. The user license clearly stated that the product was licensed and not sold. The license was protected both under the copyright law and the patent regulations.

The Tribunal held as follows:

- a) The income accruing to Microsoft for supply of software is royalty under Section 9(1)(vi) of the Act. It is taxable as a copyright in a computer programme, and it is also a literary/

scientific work. A computer program can also be termed as an invention or process. As the end users have made payments for transfer of rights (including granting of a license) in respect of copyright, patent, invention, process, literary or scientific work, the payment would be in the nature of royalty.

- b) The definition of Royalty as per the domestic law and as per the DTAA is the same.
- c) The ITAT observed that the view of the OECD commentary expressing that profits from supply of software are not royalty are but views of the Authors. Such views, in the opinion of the ITAT, cannot be regarded as court decisions or law. It was observed that a number of countries do not subscribe to such view.
- d) The judgement of the oft-quoted Tata Consultancy case (271 ITR 401) was analysed at length. It was observed that the distinction between 'copyright' and 'copyrighted article' as per the Tata case does not have application income tax cases. The Tata case was concerned with provisions of a state sales tax. The case was not concerned with the issue whether transfer of copyrighted software can give rise to royalty. The Motorola (93 TTJ 1) case was found distinguishable on the ground that in that case, software supplied was part of hardware and had no independent use.
- e) The income received by the other companies, except one was held as royalties. The income of only one entity was found to be taxable as business profit through its PE.

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#### **Millennium IT Software (AAR) 14 Taxmann.com 17)[2011]**

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The Sri Lanka based Software Company entered into a Software License Agreement with an Indian Company. Its software called 'licensed programme' was to be installed at the designated sites of the user. The owner was to also deploy its personnel for

them to be trained by the employees of the licensee. The agreement also provided for payment of 'license maintenance fee'.

According to the applicant, it had only granted the user the right to make copies of the licensed programme to be installed on equipments only at designated sites of the licensee. No transfer of IPR (intellectual property right) is involved in the process. The applicant did not have any permanent establishment in India so that its income becomes chargeable to tax. On this basis, the applicant felt that the licensee was not required to deduct tax at source.

The Authority discussed in detail the provisions of the Act, the copyright law and the provisions of the DTAA. The Authority observed the following points in particular:

- (i) Under the Indian Copy Right Law, computer programmes are literary works and entitled to copyright protection;
- (ii) In the instant case, though the source code is excluded from the preview of the agreement, the programme under license still contains the object code which is also copyright protected;
- (iii) Dictionary meaning of licensee is a person who has permission to do an act which without such permission would be unlawful;
- (iv) Any usage of the computer programme would have been unlawful once the Software Licensing Agreement is in place;
- (v) Therefore, the corresponding payment is for obtaining the right to use the copyright, and hence taxable as royalty.

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**CIT vrs Samsung Electronics Co Ltd (16  
taxmann.com141) (Karnataka)**

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The assessee was engaged in the development of computer software and export of such software developed to its head office located in South Korea. During relevant assessment years, it imported software from non-resident companies of USA, France

and Sweden. No tax was deducted at source in respect of such payments on the ground that the software imported by it was shrink wrap product and payment for its acquisition does not amount to royalty.

The Assessing Officer held that the payment made by the assessee would constitute royalty under Section 9(1)(vi) Explanation (2) and relevant clause of the DTAA with USA, France, Sweden and, therefore, there was obligation deduct tax at source u/s 195(1) and for the default for non-deduction of tax at source from the payment of the non-resident, the assessee was liable for imposition of penalty. The Commissioner (Appeals) upheld the order passed by the Assessing Officer. The Tribunal however, allowed the assessee's appeal holding that the payment made by the assessee to non-resident company would not amount to royalty within the meaning of Section 9(1) (vi) or under clauses of DTAA as it was a case of purchase of shrink wrap software. In addition, since there was no permanent establishment of the non resident company in India, the payment was not liable to be taxed in India as business income.

On the revenue's appeal, the Division Bench the High Court set aside the order of the Tribunal. It was held that tax should be deducted at source from all payments made to the non-resident companies unless certificate is obtained by making application under Section 195(2) that there is no liability to deduct tax at source. On further appeal, the Supreme Court, set aside the order passed by the Division Bench on the ground that the High Court, instead of going into the merit of the case, made a conclusion in a summary manner stating that the moment there was remittance, there is an obligation to deduct tax at source from the payment to a non-resident. This view was not acceptable to the Supreme Court. The Apex Court remitted the matter back to the High Court for deciding whether the decision of the Tribunal was justifiable.

The High Court considered again the agreements of the

assessee and the non-resident companies, provisions of the Act and the DTAA and interpretation of the term copyright while delivering the judgement. The High Court observed that the case involves transfer of copyright. The Court held that but for the granting of license by the non-resident to the assessee and the end user, the actions of the later would amount to violation of copyright. The Court analyzed that when license 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, what is transferred is right to use the software. The Court considered the issue of difference in approach of direct tax law vis-a-vis the indirect tax law. Mere finding that computer software is goods within the sales tax law, it was held, will not preclude the Court from holding that such payment is 'royalty' under the direct tax act.

Obviously, the above judgements show the divergence of judicial opinion on the issue of taxability of computer software.

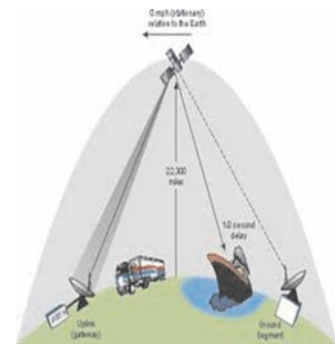
### Taxation of Foreign Telecasting Channels

A number of foreign telecasting channels operate in India. The channel companies who are tax residents of other states have their earnings in India from advertisement revenue as well as distribution revenue.

The foreign companies take the stand that they do not have a permanent establishment in India and therefore, they are not taxable in India. However, the tax authorities have taken a different position. In the views of the tax authorities, the foreign companies carry out business operations in India through dependent agents. The advertisement income is taken as business income and distribution income as royalty. The issue is yet to receive finality.

The telecasting companies use satellite communication and allied technology. Closely associated with the issue of taxation of telecasting is the issue of taxability of transponder capacity charges which is discussed below.

In modern technology, transponder plays a very important role in receiving and transmission of audio-video signals. The use of transponder is found in satellite/broadcast communication, optical communication, aviation, marine communication etc. Payment of transponder charges in the context of satellite communication is an important taxation issue.



Before discussion from the tax angle, it may be pertinent to discuss a few terminologies and concepts used in satellite communication technology.

#### Box 5.1 : What is a transponder?

*Transponder is an integral part of satellite communications. Transponder is an automatic device that receives, amplifies and re-transmits a signal on a different frequency. Thus it is an automatic device that transmits a predetermined message in response to a predefined received signal. So put simply, transponder is a receiver-transmitter that will generate a reply signal upon proper electronic interrogation.*

*A communications satellite's channels are also called transponders, because each is a separate transceiver or repeater. With digital video data compression and multiplexing, several video and audio channels may travel through a single transponder on a single wideband carrier. Original analog video only has one channel per transponder, with subcarriers for audio and automatic transmission identification service (ATIS). Non-multiplexed radio stations can also travel in single channel per carrier (SCPC) mode, with multiple carriers (analog or digital) per*



transponder. This allows each station to transmit directly to the satellite, rather than paying for a whole transponder, or using landlines to send it to an earth station, for multiplexing with other stations.

Footprint of a communications satellite is the ground area that its transponders offer coverage, and determines the satellite dish diameter required to receive each transponder's signal. There is usually a different map for each transponder (or group of transponders) as each may be aimed to cover different areas of the ground.

**How does a transponder work?** The satellites transmit the signals to us from their transmitters known as Transponders (TPs). Each satellite has up to 32 Transponder frequencies. The Transponders send a data stream on each frequency; this data stream can carry a number of channels. The faster the data stream the more channels it can carry, the speed of the data stream is rated as "Symbol Rate" (SR) per second. Most satellite Transponders use 20,000 symbols per second, which translates into 10 to 20 video/audio channels per Transponder, depending on the video resolution. Hi-Def uses more Symbol rate. Thus the Transponder can carry fewer Hi-Def. channels. Not all Transponders' are used for TV/Radio entertainment, they are used for other commercial purposes, this is why our receivers can get a Transponder that indicates "S"trenght but no "Q"uality, our receiver with its current TV/Radio software cannot decode these non-video/audio signals.

**How our receivers use the transponders?** The satellites signal is captured by our dish, and reflected into the LNB. The LNB processes, amplifies the signal and sends it up the cable to our receiver. The receiver looks at the signal frequency according to the Transponder frequency data that

is stored in the receiver's memory for that satellite. If your receiver does not have a current transponder data list in its memory, you will be missing TV/Radio channels. We get the transponder frequency lists from 2 different sources. First, we load it into our receivers as a data file; it can be buried in a upgrade file (.bin) or a separate channel file. Second, we can do a "Blind Scan"; the receiver scans the satellite for the transponders frequencies, puts these frequencies into the receivers memory and then using this frequency list, it scans each frequency for Video/audio channels, that we know as our TV/Radio channels. If you have a current receiver, it should have a fast blind scan ability (usually 10 minutes or less per satellite). I recommend a blind scan monthly, for optimum reception.

**Source: Wikipedia.**

**Payments for use of Transponder**

**Asia Satellite Telecommunications Limited vrs DIT  
51 DTR 1 (Delhi) [2011]**

The taxpayer, a Hong Kong based company, was engaged in the business of satellite communications and broadcasting facilities. This business was carried out through the medium of satellites, owned and leased, which are placed in geostationary orbits. These satellites did not use Indian orbital slots. They also did not get placed over the Indian sky space on any occasion.

The assessee entered into agreements with TV Channels & communication companies so that they are able to utilize its transponder capacity for data transmission. They could plink their signals on the transponder through their own earth stations. Such earth stations are located outside India. On receipt of the signals, the transponder amplifies the signal and sends it to the target area.



The area so covered, called the footprint area, included the territory of India.

The assessee held that its income was not chargeable to tax in India because it does not have any permanent establishment in India. In particular, it was argued that there was no office or customers in India. The Delhi Tribunal in the instant case held that despite the fact that the assessee could have business connection in India, none of its operations were carried out in India. In addition, the payment made by the customers was not for use of the equipments so that there was no equipment royalty angle in this case.

However, the Hon'ble Tribunal also held that in the facts of the case, the customers were making payment to the non-resident for use of a process. It was observed that to constitute royalty, the process need not be a secret process. The income of the non resident was ruled to be 'process royalty.'

On appeal, the Hon'ble Delhi High Court reversed the above ruling. It was held that the non resident company did not carry out any operation in India. Therefore, it cannot be deemed to have any business income. Mere presence of the footprint in India and/or the presence of the Indian audience did not in any way suggest that the company had business connection in India.

The High Court also observed that the assessee did not lease out its satellite to its customers. The customers were not allowed to use any process. The Hon'ble High Court came to the conclusion that the assessee made use of the transponder and the process in order to provide service to its customers. On the basis of the above, the High Court held the amount not to be royalty. The High Court also reversed the Delhi ITAT special Bench Ruling in the case of New Skies Satellite and the ruling of the Delhi Tribunal in the same case.

## Reimbursement of Expenses

Many times, transactions between two non-resident entities or one resident and a non-resident are claimed as reimbursement of cost. Such transaction may typically take place in the following cases:

- a) transaction between a branch of a non resident company in India and its head office abroad;
- b) transaction between the branch of a non resident company and one of more of the group concerns;
- c) transaction between a subsidiary of a non resident company and its holding company;
- d) transaction between subsidiary of a non resident company and a group company; or
- e) transaction between or two unrelated companies one of which is non resident.

Prima facie, it may appear that in case of reimbursements, the non resident has been paid what it expended so that there is no income element in such payments. In such cases, argument is often raised that there is no requirement of deduction of tax at source. However, transactions in the commercial world may not be so simple. There may be different types of agreement between the non resident and the recipient of services which are required to be analyzed from the tax angle.



These arrangements could be:

- a) Reimbursement of cost of services offered by the Non-Resident;
- b) Composite agreements where consideration comprise of Fees for Technical Services and reimbursement of expenses;
- c) Reimbursement of allocated cost among group companies;
- d) Reimbursement of third party payment charged by the Non - Resident without mark up;
- e) Reimbursement of per diem or living allowances of expatriates deputed by the Non-Resident;
- f) Direct payment of expenses and salaries of expatriate technicians by the Non-Resident; etc.

The above are only examples and there can be further permutations and combinations of the payments or reimbursements. The argument that reimbursement does not constitute income of the Non-Resident is often not accepted by the Department. The Tax Authorities may 'read into' the agreements, invoices and certification whether there is any 'income element' involved in the reimbursements. The issue has been subject of litigation. Following are some of the case laws on the subject.

#### **Decisions in favour of assessee**

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##### **Dunlop Rubber Co Limited 1421 TR 493(Cal) (1983)**

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M/s Dunlop Rubber Company is English Company. It held 51% shares in Dunlop India Limited, an Indian company. The Indian company entered into certain agreements with the English Company. By virtue of the agreements, the English Company was to provide information, processes and inventions which were to be applied or intend to apply, or in the opinion of the English Company could be used by the Indian Company in connection with the

manufacture of certain listed goods. If such information was protected by patent rights, the English Company, on request from the Indian Company, would grant royalty free license. All renewal fees and other expenses in connection with patent etc would be borne by the Indian Company. The Indian company was bound to pay a certain part of cost of acquisition of the patent etc. The Indian company would also bear all costs and expenses incurred by the English Company for collection of information. After analyzing the case, the Court came to the conclusion that the payment in this case is recoupment of expenses and not in the nature of royalty. The Court also observed that it was for the Department to show that there was some element of profit in the payment to the non- resident, in order to substantiate its stand that the payment was royalty.

##### **TELCO 245 ITR 823 (Bombay) [2000]**

The assessee company spent certain amounts towards air fare, lodging and boarding charges of foreign technicians. Before remittance of an amount, the assessee requested for issue of a no objection certificate from the Department. The Assessing Officer was of the view that tax had to be deducted at source from all the remittances and the expenses incurred were part and parcel of fees for technical services taxable under sections 44 D and 115A. The High Court examined the issue and held that there is no income element involved in the expenditure on account of foreign technicians. No tax was therefore deductible.

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##### **HCL Info Systems Limited 274 ITR 261 (Delhi) [2005]**

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Several employees of Helwett Packard, USA were deputed to M/s HCL Info systems Limited. M/s HCL deducted tax at source from the payments made to the deputies, treating such amounts as salary. Subsequently, the department raised the issue that such payments should be treated as Fees for Technical Services. The High Court agreed with the views of the Tribunal that (i) the

employees were placed at the disposal of M/s HCL so that the amounts are to be classified as salary, (ii) The Fees for Technical Services has already been separately assessed in the hands of the foreign company.

#### **Decisions in favour of revenue**

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#### **Danfoss Industries Private Limited 268 ITR 01(AAR)[2004]**

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The applicant, an Indian company was a member of the Danfoss group of Industries. It proposed to enter into an agreement with one of the group companies, i.e., Danfoss Industries Pvt. Limited, Singapore. The agreement was aimed at availing services such as advice and assistance in the preparation and conduct of marketing research, financials matters, customer training, employee relations etc. The consideration for such services was fixed on the basis of a pre-determined allocation key. The charge was payable on a monthly basis.

After examining the agreement in detail and facts of the case, the Authority came to the conclusion that there was no direct nexus between the actual cost incurred by the Danfoss Singapore and the fee payable by the applicant Indian Company. Even assuming that there was no profit element embedded on the consideration, the consideration was nothing but quid pro quo for the services rendered and not a pure case of reimbursement of expenses. The consideration was held to be in the nature of Fees for Technical Services.

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#### **Timken India Limited 273 ITR 67 (AAR) [2005]**

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Timken India Limited is an Indian Company which is a subsidiary of US Company called the Timken Company. The Indian Company is engaged in the manufacture of bearings and other ancillary products. The US Company agreed to provide certain services to the Indian Company outside India on cost basis, without

any markup. The short issue before the Authority was whether the remittance was tax deductible under Section 195. After examining the facts in detail and referring particularly to several decisions, the Authority concluded that the amount involved cannot be said to represent only the reimbursement of expenses actually incurred by the head office in the USA. The amount was held to be taxable as Fees for Technical Services.

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#### **Wallace Pharmaceuticals (P) Ltd [2005] (2005) 278 ITR 97 (AAR)**

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In this case, the resident assessee entered into an agreement with an American Company for availing consultancy services. The aim of the agreement was expansion of the business of the Indian Company in India as well as abroad. As per terms of the agreement, the resident company had to make the following payments: (i) consultancy fees, (ii) commission and (iii) reimbursement of third party payments (legal fees). It was held that the services of the non resident had been utilized in India and the services were not for the purpose of earning of income of the resident company outside India. Consequently, it was held that the resident company had to deduct tax at source from all the payments.

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#### **Verizon Data Services (P) Ltd In re AAR No865 of 2010 [II taxmann.com 177-2011]**

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The applicant is a wholly owned subsidiary of a US company, Verizon LLC (US). The Indian company is engaged in providing services relating to development and maintenance of telecom software solutions and certain information technology enabled services. The Indian company works for its parent company only as a service provider. In order to increase the efficiency of services, the parent company sent three executives from one of its group companies. A secondment agreement was entered into, between the Indian subsidiary and the group company. As per terms of the agreement, the US Affiliate Company was to pay to the employees

for their entitlements and Verizon India was to reimburse the US Affiliate Company the cost of such entitlements paid by it to the employees. The seconded employees, during the deputation period, would work exclusively under the direction, control and supervision of Verizon India.

In the views of the applicant, the US Affiliate Company did not render any services to Verizon India through its expatriate employees. The reimbursement of salary cost paid by US Affiliate Company in respect of provision of personnel to Verizon India, it was argued, was only for administrative convenience and should not qualify as 'Fees for Included Services' (FIS) under India-US DTAA (DTAA). It was argued that the managerial/ consultancy services were not made available to the Indian Company so that it was the ambit of taxation as per DTAA also.

After analyzing the case, the AAR ruled that in terms of the Secondment Agreement, the seconded employees shall remain the employees of the US Affiliate Company and payment of their salaries is not dependent on Verizon India. It further implied that the managerial services performed by the deputies are as employees of the US Affiliate Company and not as employees of Verizon India.

The AAR observed that income had accrued and arisen to the non resident group company and the income is of the nature of Fees for Included Services. Importantly, in the views of the AAR, 'make available clause' is applicable in respect of technical service and not in respect of managerial service. The Authority ruled out any incidence double taxation in respect of taxation of the salary income of the deputees. In the views of the Authority, income had arisen to the group company and the salary paid to the executives represents salary received by the executives out of that income. Therefore, while tax is deductible in the hands of the foreign company for the deemed technical services, salary received by the employees in India are separately tax deductible as salary.

The ruling is similar to the ruling in Cochin Refineries Limited 135CTR 193(Kerala) and ruling of the Authority in AT&S India Private Limited [157 Taxmann 198- 2006]. However, the above view is contrary to the views of the judiciary in the cases of HCL Infosystems Ltd, IDS Software etc. In those cases, it was held that reimbursement of salary cost of seconded employees to the foreign company would not be subject to tax in India.

### **Royally & Cloud Computing Models**

National Institute of Standards and Technology in the US has defined Cloud Computing as a model for enabling convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction. This means that the computing power resides in the cloud signifying that the end-user is not likely to know the physical location or configuration of the system that delivers the services. The royalty issues on Cloud Computing can be as below:

- **Software as a Service (SaaS):** Whether fees for SaaS usage for *use of scientific equipment* are taxable as royalty? The issue arises because SaaS model is represented by a seller which retains the custody over software given to the customers/clients for its use. SaaS model therefore involves granting of license to the end-user to use particular software. The end-user accesses the software through the internet. The clarificatory amendment in Explanation 4 to Section 9(1)(vi) of the IT Act brings this into the ambit of transfer of royalty. Explanation 4 states "*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.*"

- **Platform as a Service (Paas):** Whether the user of PaaS gets right to make derivative programme from the existing software and sell new applications to other web users and this right to use the copyright of scientific work can be faxed as royalty? In PaaS software developers can avail the platform services to develop various applications without installing and maintaining any tools on the computer. The PaaS model is often considered to be granting tools and skills/rights to create derivatives of programmes from already existing platforms. While granting tools and skills/rights, the service provider fact gives right over its copyright on the platform. This amounts to granting of rights/copyrights/licenses, and thus would be covered under Explanation 2 and Explanation 4 fo Section 9(1)(vi) of the IT Act.
- **Infrastructure as a Service (IaaS):** Whether the consideration for the hardware cloud infrastructure allowed to user are royalty/FTS/Use of equipments? Under the IaaS Model instead of purchasing a large costly infrastructure such as data center, virtual servers, network infrastrucfure and other data storage equipments, etc, the users of IaaS source the same from third party service providers. The payment mechanism is generally “pay as you use”. The infrastructure so provided, if it is outside India, the taxability of the same as business income poses tricky questions. What is key to note, in this respect is that the control over the hardware infrastructure remains with the service provider. This means that in effect that end-user is only getting the right to host and store the data on such hardware infrastructure. The subject matter of transfer is thus not the hardware infrastructure but the right to host and store the data on such hardware infrastructure. This would get covered under Explanation 2 and Explanation 5 to Section 9(1)(vi) of the IT Act. Explanation 2 states that the royalty would include the use or right to use any industrial, commercial or scientific equipment,

- and Explanation 5 clarifies 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.

### Conclusion

From the above discussion on the issues and decisions, it is apparent that the issues are complex and often debatable. There is also considerable divergence in judicial views as was seen recently in the case of shrink-wrapped software where the Karnataka High Court said that the subject was taxable, where as the Delhi High Court held otherwise. The Mumbai ITAT interestingly followed the view which was favourable to the assessee.

What is also being seen of late is that taxation of receipts as business profits is becoming increasingly challenging in the face of e-commerce and use of technology for transfer of goods/rights. Establishing a PE has always been a complex exercise; more so for business profits attributed to PE. Further the technology is supporting non-establishment of physical PE, which often leads to complexities, not only for determination of PE but to decipher a particular transaction.

The taxation of technical services has also become very critical in view-of increased cross-border flow of services, high value of the transactions and deductibility of tax in the source country. Sometimes, the recipient of the services can also constitute a source. The characterization of FTS income has thus become challenging. The taxpayers often declare FTS as business income claiming it as non taxable in absence of PE. This is particularly



from taxpayers of those countries which do not have FTS Article in the DTAAAs of their countries. Further, non-taxability is also claimed on the ground that the transfer of technology or service does satisfy the “make available” conditions of the DTAAAs, if it is so available.

## **CHAPTER 6**

### **Royalty and Transfer Pricing**

Royalty is basically payment for the use of, or the right to use, something that is owned by the payee. The ‘something’ is an intangible property, which may be of two types - trade intangibles and marketing intangibles. Trade intangibles include patents, knowhow, designs and models used for production of goods and services and computer software. Examples of marketing software include trademarks or trade names/brand names, logo etc. The definitions of royalty in accordance with the Income Tax Act and the model conventions are wide enough to cover both types of intangibles.

Historically, in many situations, the owner of the royalty is a resident of a developed country. The transaction regarding payment of the royalty may be between two entities belonging to the same group, technically called associated enterprises.

The transfer of intangible between related parties may be either through sale or through licensing. The more popular and widely used way of transferring intangibles between related parties is through the use of exclusive or non-exclusive licence agreement. There are many ways to structure such licensing agreements, the simpler among them may be in these forms:

- (i) A fixed annual fee
- (ii) A fee based on a percentage of licensee’s sales of the licensed products

The taxation issues associated with royalty in the foregoing chapters were concerned with the following issues:



- a) Characterization of the payment- royalty/ business profit/ capital gain
- b) Taxability as per domestic act
- c) Taxability as per the treaty.

However, when the transaction of payment of royalty is between two affiliates or associated enterprises, there is another issue involved: transfer pricing. The transfer pricing comes in because it becomes necessary for the tax authorities to know whether the payment between the two affiliates are at arm's length. The transfer pricing analysis may not result in increase in the tax liability of the non resident entity as such. However, it may affect the tax liability of the payee entity and the overall tax burden of the group as a whole. The points just mentioned will become further clear from the discussions in the subsequent paragraphs. However, it may be worthwhile to have an elementary discussion on 'transfer pricing'

***What is transfer pricing***

*Business of Multinational companies is spread across the world. For cost related, technology related reasons or for other economic, commercial and legal reasons, a good number of transactions of a multinational company is either with the parent or the other group companies. In taxation jargons, such companies are called **associated enterprises**.*

*The prices associated with the transfer of goods of services from associated enterprise to another are often a matter of concern for the tax authorities of the respective jurisdictions. This is because, since the entities are related, they can plan their affairs in such a way that the overall tax liability of the group is reduced. In other words, the price that one group company or the parent company charges another group company for transfer of goods or services may not*

*be the market price. The market price is the price which two independent, non associated parties are involved in a commercial or economic transaction. In taxation jargons, the market price is known as the arms length price.*

*In transfer pricing, the transfer pricing authorities attempt to find whether the price charged by the associated enterprises represent the arms length price.*

*The arms length price is found out not arbitrarily but through some prescribed methods. The Income Tax Act has prescribed five such methods and the TPO is to the most appropriate method as applicable in a given case. The prescribed methods are*

- *Comparable uncontrolled Price Method (CUP)*
- *Resale price Method (RSM)*
- *Cost Plus Method (CPM)*
- *Profit Split Method (PSM)*
- *Transactional Net Margin Method (TNMM)*

*As usual, the most appropriate method applied by the TPO and the Arms Length Price (ALP) of the International Transaction is often at variance with the method used and price determined by the taxpayer. The taxpayers have to approach the appropriate forums for adjudication on such issues.*

There are again two possible questions those may be raised in the royalty related transfer pricing issues.

**Question 1:** Whether the payment of royalty from one of the related parties (typically located in a less developed country) is necessary or it represents excess payment. In other words, it may be doubtful whether the underlying intangible property is particularly

valuable. Even a doubt may be raised that such an arrangement in first place would not be made between two independent parties.

**Question 2:** Whether the entity which is the user of the royalty should be compensated for its functions performed, assets used and risks undertaken for developing in the intangible. The related concept is the concept of economic ownership. In the license scenario, the licensor is the legal owner. The economic ownership, on the other hand, is based on facts. The licensee may become an economic owner in the sense that bears the greater cost in developing the intangible. Across the world, a burning issue is that the licensee should be adequately compensated for its efforts by the legal owner.

In pure taxation and transfer pricing terms, the above two questions are viewed as follows:

The first question is associated with the genuineness of the transaction. The expenditure by the licensee may be disallowed while determining its income. The expenditure may also be allowable to the extent of 'arms length price'. The transfer pricing officers would apply the transfer pricing methods to find the arms length price.

In cases where the second question is raised, the transfer pricing authority, while determining the arms length price of the license payment made by the licensee, would adjust any compensation that should have been received by the licensee for its marketing efforts.

### **Bright Line Concept**

The bright line concept in the context of royalty, is a popular usage. The concept is in connection with the question regarding the compensation that should have been received by the economic owner of an intangible. The Bright line concept recognizes the business reality that every licensee need to incur some expenses

(advertisement, sale promotion, etc) in relation to the intangible for which royalty is paid to the licensor. However, if the investment of the licensee crosses the 'bright line' of routine expenses, the licensee becomes an economic owner. The economic owner in that case becomes entitled to economic return from the legal owner (licensor). There are a few international cases based on this concept, the maximum such cases reported in the US.

### **The Maruti Suzuki case**

The Maruti Suzuki case is an attempt of the Indian Tax Authorities on the concept of the economic ownership. Maruti Suzuki India Limited is an established company in the Indian car market. Its registered trademark was 'M'. In 1993, it entered into a license agreement with M/s Suzuki Corporation of Japan. Since 1993, Maruti replaced its logo by "S" on the front side of the car. However, it continued to use the use 'Maruti' along with 'Suzuki' at the rear end of the car. For the Assessment year 2005-2006, the TPO observed that the replacement of logo 'M' amounted to its sale to Suzuki. The 'sale', according to the TPO, resulted in benefit to Suzuki since Maruti was an already established brand in India. This is what the TPO termed as 'piggybacking' by Suzuki. Observing that Suzuki did not make any payment to Maruti for this, the arms length price of royalty actually paid by Maruti was valued at 'Nil'.

Maruti challenged the TPO's approach in a writ petition. The High Court noted that the Department did not bring out its case very well. The case was sent back to the TPO for fresh determination of the Arms Length Price of Royalty.

The issue of valuation of Royalty in relation to transaction between two related parties is an emerging and controversial issue worldwide in the domain of transfer pricing. In India, it is almost certain that tax authorities and the taxpayers alike will be grappled with this issue in the coming years. The OECD has already

expressed the view that companies and tax authorities should give careful attention to the valuation of intangibles. In the long run, a suitable 'Advance Pricing Mechanism' may bring more stability into the issue of determination of arms length price for intangibles, as in the case of ALP of any other goods or services.

## CHAPTER 7

### **Royalty & Fees for Technical Services and Provisions of the proposed Direct Taxes Code**

The proposed Direct Tax Code (DTC) has provisions for taxing royalty and FTS income of non residents or for that matter, taxation of income of non residents. Before the discussion on the specific topics on royalty and FTS vis-a-vis the DTC is taken up, it is better to have some introductory idea about the provisions of the DTC.

#### **Preliminaries Charge of Tax**

The liability to pay and charge of income tax is provided in Section 2 of Direct Tax Code. According to that Section, every person is liable to pay income tax in respect of his total income for the financial year.

Like other terms, the definition of 'person' is contained in Chapter XIX of the Code, which is the chapter on 'Interpretations and Constructions'. An individual, a HUF, a company, a cooperative or any other society, a firm, a non profit organization and certain other including a local authority is included in the definition of person.

#### **Residential Status**

Section 4 of the Direct Tax Code deals with residential status of an individual, based on 'day count' formula. A company is to be treated as resident if (a) it is an Indian Company or (b) its effective management and control is in India during any time of the year. Other entities would be taxable if the control and management of its affairs are fully or partly in India. The flip side of the above criteria fixes who is a non resident.

The phrase 'effective management' has not been defined in the Code. Facts of a particular case and the related interpretation will lead to the conclusion whether its effective management is in India. Some existing judicial decisions may be of relevance here. On the international front, one land mark case law rule for determining the residence of a company is the De Beers Consolidated Mines Ltd. v Howe, 5 TC 213. The De Beers Company was incorporated in South Africa and its main trading operations were there. The controlling board of directors exercised its powers in the UK. The company was held to be resident in the UK.

In the above case, 'effective management' was located in the UK despite the fact that the company was incorporated in the Republic of South Africa. Therefore, facts of each case should be analyzed so as to find the location of the central control. Effective management lies where the central control is.

### **Scope of Total Income**

Section 3 of the DTC deals with scope of total income - source rule taxation for non residents. All income from whatever sources derived by a non resident which accrues or deemed to accrue to him India or received or deemed to be received in India on his behalf in a particular year will be taxable in that year.

### **Deeming of income**

Section 5 of the DTC covers the deeming of income. Royalty and FTS are deemed to accrue in India, like other types of deemed income, if certain conditions are satisfied, 'pay factor' and 'use factor' are the basis of taxing Royalty and FTS.

### **Computation of Total Income**

Chapter III of DTC deals with computation of total income. Section 13 classifies the sources of income into two categories:

- a) Income from ordinary sources.
- b) Income from Special Sources.

Income from employment, Income from House Property, Income from Business, Capital Gains and Income from Residual Sources belong to income from ordinary sources.

Income from Special Sources is contained in Part III of the First Schedule to the Code. Royalty and FTS of Non Residents belong to income from Special Sources, like income of non citizen, non resident sports persons or income from lottery etc. of residents or non residents.

The computation provision for income from special sources is in accordance with provisions of the ninth Schedule to the Code. However, income from special sources including Royalty and FTS from non residents will not be taxable under 'special provisions' if such income is attributable to the Permanent Establishment of a non resident in India.

In case the non resident has a permanent establishment in India, its income will generally be governed by provisions of computing business income. In case the income of the non-resident is of certain special types, like business of civil construction in connection with a 'turn-key' power project will be taxed on a presumptive basis. Such presumptive taxation of non residents is provided in the Fourteenth schedule to the Code.

### **Taxation of Royalty and FTS in DTC**

With the above background, we can make a quick round of the taxation provisions of DTC concerning Royalty and FTS. Royalty and FTS accrued from the government or a resident is taxable in India. Royalty or FTS accrued to a non resident for the purposes of a business carried out in India or earning of any income from any source in India is deemed to accrue in India. However, royalty accrued from a resident for the purposes of a business

carried out by the resident outside India or earning any income from any source outside India is outside the deeming provision. Similarly, FTS accrued from a resident in respect of services utilized for the same purposes is outside the deeming provision.

There is still another type of exclusion in the deeming provision of Royalty. Royalty, which consist of lump sum consideration accrued from a resident for the transfer of any rights in respect of computer software supplied by a non resident manufacturer, along with a computer or computer based equipment, under any scheme approved under the policy on Computer software export, Software Development and Training, 1986 is also not included in the 'deeming net'. Transfer of any right, as clarified, also includes granting of a license by such non-resident manufacturer.

In respect of Fees for Technical Services, consideration for any assembly, mining or similar project undertaken by the recipient or consideration which would be income from employment of the recipient, would not come in the deeming net.

### **Royalty and FTS - definitions**

The DTC attempts to give compressive definition of Royalty and FTS in the 'Interpretation Chapter'. In respect of royalty, among other rights, the use or right to use of transmission by satellite, cable, optic fiber and similar technology has been specifically included in the definition. Consideration in respect of development and transfer of a design, drawing, plan or software or similar services has also been included in the definition of Fees for Technical Services. The full text of the definitions is given in Annexure -13 [Section 314 (97) and 314(220) of the Code].

### **Computation Provisions**

The computation provisions for income from special sources, including income from royalty and FTS is laid down in the ninth Schedule to the Code. Following are the salient features of the computation provisions:

- Income from special sources including royalty and FTS are taxable on gross basis
- Income from special sources will be the sum total of
  - amount of accrual/ receipt
  - amount received as reimbursement of any expenditure
  - amount of tax borne by the payer
- No deduction or allowance or set-off of loss will be allowed in the computation of income from such special sources.

The income computed from special sources is to be taxed at flat rate of 20%, as provided in the first schedule.

### **Provisions relating to Relating to Tax Deduction at Source**

Section 195 of the code deals with the issue of tax deduction at source for residents as well as for non -residents. The rates of deduction of tax at source for royalties and FTS are given in the Fourth Schedule. The Fourth Schedule provides that the rate of tax deduction for at source is 20%. The taxpayers can also apply for a lower deduction or a nil deduction certificate, as per Section 197 of the Code.

### **DTC provisions vis-a-vis DTAA provisions**

Section 291 of the Direct Tax Code deals with this issue and provides that

- Where the Central Government has entered into Double Taxation Avoidance Agreement with other states; or
- Where the Central Government has entered into an Agreement for Avoidance of Double Taxation with a specified territory, the provisions of the DTC or the provisions of the Agreement, whichever is more beneficial to the taxpayer, will prevail.

This section also provides that any person seeking relief under the DTAA must obtain a tax residency certificate of the other state. The Certificate should be in the specified form. The Direct Tax Code also provides certain special provisions as below:

- General Anti Avoidance Provision (GARR)
- Levy of Branch Profit Tax for branches of foreign companies
- Provisions relating to Controlled Foreign Company.

In relation to application of DTC provisions relating to the above, the provisions of DTC will apply, even if they are not beneficial to the assessee.

#### Requirement of Permanent Account Number (PAN)

Section 292 of the Direct Tax Code, is concerned with the requirement of obtaining Permanent Account Number (PAN). The provisions relating to Tax Deduction at Source has a reference to the provisions relating to PAN and provisions relating to DTAA. The corresponding provisions provide that where the tax deductible payment is made to a resident of a DTAA country, the rate of tax deduction will be the rate as per Fourth Schedule or the rate as per DTAA, whichever is lower. However, if the non-resident deductee fails to obtain a PAN, the rate as per Fourth Schedule or the rate of twenty percent, whichever is higher, will apply.

Summary of the TDS implications in respect of non-resident assessee having income of the nature of Royalty/FTS is given below:

| Sl.No. | Particulars of non resident            | If PAN is obtained        | If no PAN is obtained |
|--------|--|---------------------------|-----------------------|
| 1.     | Non resident belongs to a country with | Fourth Schedule Rate: 20% | Fourth Schedule       |

|    |  |   |   |
|----|--|---|---|
|    | which there is no DTAA and income in India comprises Royalty/FTS (no PE)   |   | Rate (20%), or 20 % both being the same-20% rate will apply                   |
| 2. | Non resident belongs to country with which there is DTAA and income in India comprises Royalty/ FTS (no PE), but the non-residence has not obtained Tax Residency Certificate in the specified form                  | Fourth Schedule Rate: 20% (DTAA cannot be resorted to.)         | Fourth Schedule Rate (20%) or 20% both being the same-20% rate will apply     |
| 3  | Non-resident belongs to a Fourth Schedule country with which there is DTAA and income in India comprises Royalty FTS (no PE) and the non residence has not obtained Tax Residency Certificate in the specified form. | Fourth Schedule Rate (20%) or the DTAA rate, whichever is lower | Fourth Schedule Rate: (20%) or 20% both being the same - 20% rate will apply. |

Compared to the present I-T Act, DTC provisions relating to royalty and FTS as also the TDS provisions are more direct in approach. Attempt has been made to make the definitions exhaustive rather than inclusive ones. There some stringent provisions in the code so that treaties may not be abused for the



purpose of tax evasion. The details of the other DTC provisions, i.e, provisions relating to Branch profit Tax, Controlled Financial Companies and Presumptive Taxation are not discussed in this chapter. The tax deduction rates applicable to other types of payments (other than Royalty/FTS) are also not discussed.

## CHAPTER 8

### Frequently Asked Questions (FAQs) on Royalty & FTS and Related Matters

This chapter contains a few FAQs in the matter of taxation of Royalty and FTS. The answers have purposely been made elaborate in order to make them broad based and clarifying the provisions.

#### Question 1:

**For Royalty or FTS, is surcharge applicable over and the rate of tax specified in a treaty?**

**Analysis:** Under the Income Tax Act, any special rate of tax (on capital gains, royalty income under Section 115A etc), the tax computed is to be increased by applying surcharge and education cess etc. The definition of tax in the treaties is however, 'all in one type'. Therefore, no additional surcharge and education cess is to be applied over the treaty rate.

In other words, for special rates specified in the treaty, presumably, the surcharge and education cess etc. are already included in the rate. However, for other types of income like business income etc. which are assessed according to the domestic tax law, the tax once computed applying the rate table, will have to be increased by surcharge and education cess.

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#### Question 2:

**An Indian distributor has made payment of royalty to a Japanese Film company. The royalty is on account of the**

**‘right to exhibit an animation film’. The Japanese company retains the ownership so that the transaction is not one of capital gain or outright sale. Now, the definition of royalty under the Income Tax Act does not include the consideration for exhibition of cinematographic films. However, the India-Japan DTAA definition of royalty includes consideration for the ‘use of, or right to use, any copyright of literary, artistic or scientific work including cinematographic films’..... Will the consideration in question be taxable in view of such inclusion in the treaty?**

**Analysis:** It is to be remembered that a Double Taxation Avoidance Agreement is not a taxing statute. The systematic steps in application of a DTAA provision is that first one has to find the taxability of an item of income or a transaction in terms of the Income Tax Act. If the item of income or the transaction is taxable in terms of the provision of the Act, then only one has to apply the DTAA. The provision of the DTAA or the Act whichever is beneficial will prevail.

Royalty income of a non-resident is taxable in India as per ‘pay rule’. However, in the instant case, the receipt is not royalty as per definition of the act. The receipt is also not a business income since (i) no sale of the right has taken place or, in the alternative, (ii) prima facie, there is no ‘business connection’ of the Japanese company in India as per provision of Section 9 (1)(i) of the Act. Therefore, not only there is no business income, can be deemed in India also. Therefore, the item will not be taxable as royalty even if the treaty provision stipulates such receipt as royalty.

It is altogether a different question to analyze and find out the place of accrual of the Income in the instant case under the full facts and circumstances of the case. If the income is found to accrue in India, though it is not royalty or business income, it can be taxed under the domestic act as ‘income from other source’.

The Indo-Japan Treaty provides for taxation of ‘other income’ in the state in which it arises.

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**Question 3:**

**The branch of a Sweden based company located in India makes a payment to its parent office for the right to use scientific equipment. It is assumed that in the facts and circumstances of the case, the payment cannot fall under any other category such as payment for use of or right to use a patent, invention, model etc. Find whether such payment is taxable as royalty.**

**Analysis:** On the basis of the domestic law provision such payment is in the nature of ‘equipment royalty’. However, the definition of royalty as per India -Sweden DTAA does not cover ‘equipment royalty’. The treaty provision being more favourable to the non-resident will prevail.

It is also important that in this instant case, it is not possible to explore the taxability of the sum as ‘Income from other sources’. The logic is as follows:

The income is taxable as royalty as per the domestic act

- a) The receipt does not have the character of royalty as per Article 13 of the India -Sweden DTAA.
  - b) It is not taxable as ‘other income’ in the treaty. This is because, Article 22, dealing with other income, is applicable only in respect of items of income which are not dealt with in any other article in the convention. Article 12 of the convention has specifically dealt with income of the nature under consideration. Therefore, it is not possible to explore the taxability as ‘other income’ as it might be possible in the previous example.
-

**Question 4:**

**An Indian subsidiary of a Hong Kong based company has been making payment for ‘Fees for Technical Services’ by virtue of agreement dated 1<sup>st</sup> August, 1997. The Assessing Officer holds that since the agreement is between 31<sup>st</sup> May and 1st June 2005, the applicable tax rate as per section 115A is 20% of the fees payable.**

**The deductor holds that since Hong Kong has become a part of China with effect from 1.7.1997, the DTAA between India and China should be operative. As a result, the tax should be deducted @10% as per the Treaty. Is the taxpayer correct?**

**Analysis:** With effect from 1.7.1997, Hong Kong has become a Special Administrative Region (SAR) of the People’s Republic of China. DTAA provisions do not apply to territories which have a special status and not a part of the country.

Article 3 of the Treaty definition of China does not extend to Special Administrative Regions of V China. Therefore, provisions of the treaty cannot be applied. The transaction will be governed by the domestic law provisions. On the basis of the date of the agreement, the tax has to be deducted @ 20%, plus applicable surcharge and education cess.

**Question 5:**

**An Indian firm makes payment to a US Company for the right to use customized software as ‘license fee’. The definition of royalty as per the Income Tax Act does not specifically mention consideration for software. In the previous discussion it was mentioned that a treaty is not a taxing statute. On that logic, does it mean that such payment should be taxed as royalty?**

**Analysis:** The definition of royalty as per the Income Tax Act, among others, include ‘consideration for the transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work...’. The domestic act definition is wide enough to cover licensee fee payable for customized software. Therefore, the premise that license fee for customized software is not taxable as per the act is not correct.

**Question 6:**

**Should tax be deducted from commission payable to export agents, treating the commission as ‘Fees for Technical Services’?**

**Analysis:** The Central Board of Direct Taxes had issued Circular No 786 dated 7<sup>th</sup> February 2000 regarding taxability of export commission and liability of deduction of tax thereon. In the Circular it was generally held that no tax is to be deducted from such commission. The Board, by its Circular No 7 dated 20th July 2009 has withdrawn this circular. By virtue of the same circular, Circular No 23 dated 23rd July,1969 in the matter of business connection of a non resident has been withdrawn.

The present question has assumed significance particularly because of withdrawal of Circular No 786. However, it is to be remembered that the reason the Central Board of Direct Taxes has cited for withdrawal of the above two Circulars is that they were being misused. However, withdrawal of Circular No 786 does not automatically mean that tax has to be deducted at source from commission payable to all export market agents.

One has to remember that at the first place, income of the non-resident has to accrue or arise or deemed to accrue and arise in India, for tax to be deducted at source under Section 195. In all the cases where export market commission is payable, one cannot hold that income of the foreign agent has accrued or arisen or is deemed to accrue or arise in India.

In some of the cases, based on facts and circumstances, the department can hold the view that the commission agent has rendered technical, management or consultancy services and the commission is actually fees for technical services. If the agent is a tax resident of a DTAA country, again a test has to be applied on the basis of the DTAA definition of FTS for that particular country.

In certain other cases, based on facts and circumstances of the case, the Assessing Officer may hold that the foreign agent has business connection in India through the exporter or otherwise. In that event, portion of the income of the agent as is attributable to operations in India may be deemed to accrue or arise in India. Even in those cases, if DTAA persists, it is to be tested whether the foreign agent has a permanent establish in India, for the corresponding income to be taxable.

In other words, it is not correct to give a categorical reply that since the circular no 786 has been withdrawn, tax has to be deducted from all commission payable to export agents.

*The Board had issued Circular No 23 incorporating examples of establishment of business connections. Circular no 786 was issued on the taxability of commission receivable by export market agents. Board issued Instruction no 1829 in the matter of taxability of receipts in power projects executed by consortium of foreign companies.*

*On the basis of the observation that the above circulars and the Instruction is widely misused, the Board had withdrawn the above circulars by Circular no 7 of 2009 dated 22nd October, 2009 and the Instruction, by Instruction No 5, dated 20th July, 2009.*

#### Question 7:

**A Private Indian Management College in India has a tie up with a UK based University. By virtue of the tie up, the Engineering College would send its faculty members for getting further training in modern technological driven instructional methods. The faculty members, once trained, are expected to apply the modern methods and techniques while teaching the students. The UK University charges a consideration for the services. Determine whether the fee is taxable. Also determine if the University was located in Germany instead of the UK.**

**Analysis:** The payment is definitely in the nature of 'Fees for Technical Services' as per the domestic act. Apparently, the payment also falls in the category of technical or consultancy services. In addition, the service makes available technical knowledge, experience, skill etc. to the trainee faculty members so that the fee charged by the University is taxable as Fees for Technical Service.

However, if the University is UK based and it a tax resident eligible to claim the benefit of India -UK DTAA, the amount will not be taxable. This is because, the amount is payable 'for teaching in or by educational institutions' which is outside the purview of Royalties as per Indo-UK DTAA. This provision is mentioned in Article 13.5 of the Treaty.

In case the University is based on Germany, the amount falls in the category of 'Fees for Technical Services'. There is no need to apply the additional 'make available' clause since this clause is not there in the India Germany DTAA. There is no exclusion in respect of 'teaching in or by educational institutions' as in the case of the Indo-UK DTAA. The amount will be taxable.

**Question 8:**

**What would happen if in the previous example, the foreign institutions are tax exempted entities?**

**Analysis:** The fact that the income of an entity is exempt from tax does not make that income automatically exempt from tax in India. However, courts do not concur with the other extreme argument that since the entity is tax exempt, it is not a tax resident and not entitled to the benefit of DTAA. In the Aazadi Bachao case (263 ITR 706), the Hon'ble Supreme Court has held that meaning of 'liable to tax' is different from 'subject to tax'. Generally, an entity can claim treaty relief if it liable to tax, though not 'subject to tax'. Depending on full facts of the case, the foreign entities can claim to be tax residents and make their case for appropriate relief.

*The following three questions are taken from the Memorandum of Understanding (MOU) dated 15th May 1989 concerning Fees for Included Services in Article 12 in respect of the Double Taxation Avoidance Agreement between India and USA . Question 9 is concerned with Para 4(a) of Para 12 of the DTAA. Questions 10 & 11 are concerned with Para 4(b) of the DTAA.*

**Question 10:**

**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 US 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?**

**Analysis:** In this example, the provision of cleaning services by the U S company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4(a).

**Question 11**

**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 US 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"?

**Analysis:** The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill and processes.

**Question 13**

**Facts:** A US manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the US 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 for included services?**

**Analysis:** The fees would not be for included services. Although the US Company is clearly performing a technical service, no technical knowledge, skill, etc., are not made available to the Indian company, nor is there any development and transfer of a technical plan or design. The US Company is merely performing a contract manufacturing service.

**Question 14**

**What are the differences among applications under sections 195(2), 195(3) and 197 in terms of (a) who can apply (b) what the application is for and (iii) whether the order of the Assessing Officer is appealable under the Income Tax Act.**

**Analysis:** Please refer to the elaborate discussion made on chapter 4. The reply to the question given above is summarized as below:

| Section | Who can apply  | What the application is for   | Whether the decision of the Assessing Officer is appealable under the incomeTax Act   |
|---------|--|---|---|
| 195 (2) | The person responsible for paying any sum to a non resident. | The application may be made if the payer considers that the whole of the sum payable to the non resident is not tax deductible. The application is a request for determination of the appropriate proportion of the Sum | If the deductor, as per terms of the agreement with the non resident (i) is to be borne by the payer (ii) such payment is made to |

|         |                                   |   |  |
|---------|-----------------------------------|---|--|
|         |                                   | chargeable to tax   | the credit of the Government but claims that no tax was required to be deducted, can file an appeal before the Commissioner (Appeals) under Section 248 of the Income Tax Act. |
| 195 (3) | The Non resident recipient itself | Application in made for grant of a certificate authorizing payment with nil deduction of tax. The non resident has to fulfill certain conditions as per Rule 29 B.  | The decision of the AO is not appealable.  |
| 197     | The non resident recipient itself | Application is made for grant of a certificate authorizing payment with nil deduction of tax or for deduction of tax at a lower rate. Unlike the case of section 195(3), the assessee is not required to fulfill any condition here. However, the Assessing Officer has to be satisfied that total income of the non resident for the year justifies no deduction or deduction at a lower rate. | The decision of the AO is not appealable.  |

**The following point is important: If a person who has not deducted tax under section 195 is held as an assessee in default under section 201(1), he can file an appeal before the Commissioner (Appeals).**

The above FAQs are not at all exhaustive and there may be many such questions possible. However, in each of such situations, the facts and circumstances of the case has to be analyzed and the provisions of the Act and the Treaty are to be applied carefully.

**Extract of Section 9(1) (vi) and 9(i)(vii): deemed accrual of royalty and Fees for technical service and definition of royalty and Fees for technical service**

Section 9 (1)

The following income shall be deemed to accrue or arise in India:-

- (vi) Income by way of royalty payable by
  - (a) the Government; or
  - (b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of 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 royalty is payable in respect of any right, property or information used or services utilized for the purposes of 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:

Provided that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum consideration for the transfer outside india of or the imparting of information outside India in respect of any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, if such income is payable in pursuance of an agreement made before the 1st day of April, 1976 and the agreement is approved be the Central Government:

Provided further that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum payment made by a person, who is a resident, for the transfer of all or any rights (including the granting of a licence) in respect of computer software supplied by a non resident manufacturer along with a computer or computer based equipment under any scheme approved under the Policy on Computer Software Export, Software Development and Training, 1986 of the Government of India.

#### **Explanation 1**

For the purposes of the first 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; so, however, that, where the recipient of the income by way of royalty is a foreign company, the agreement shall not be deemed to have been made before that date unless, before the expiry of the time allowed under sub section (1) or sub section (2) of section 139 (Whether fixed originally or on extension) for furnishing the return of income for the assessment year commencing on the 1st day of April, 1977 or the assessment year in respect of which such income first becomes chargeable to tax under this Act, whichever assessment year is later, the company exercises an option by furnishing a declaration in writing to the Assessing Officer (such option being final for that assessment year and for every subsequent assessment year) that the agreement may be regarded as an agreement made before the 1st day of April, 1976.

#### **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 equipments but not including the amount 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).

#### **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;

- (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 utilized 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:

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".

- (2) Notwithstanding anything contained in sub section (1), any pension payable outside India to a person residing permanently outside India shall not be deemed to accrue or

arise in India, if the pension is payable to a person referred to in article 314 of the Constitution or to a person who, having been appointed before the 15th day of August, 1947, to be a Judge of the Federal Court or of a High Court within the meaning of the Government of India Act, 1935, continues to serve on or after the commencement of the Constitution as a Judge in India.

**Explanation** -For the removal of doubts, it is hereby declared that for the purposes of this section, where income is deemed to accrue or arise in India under clauses (v), (vi) and (vii) of subsection (1), such income shall be included in the total income of the non resident, whether or not the Non - Resident has a residence or place of business or business connection in India.

**Relevant extracts on Royalty and Fees for  
Technical Services from**

**Model Conventions**

**Article 12 of UN Model Tax Convention**

1. Royalties arising in a Contracting State and paid to a resident of the Contracting State may be taxed in that other state.
2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that state, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed per cent (the percentage to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
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 cinematographic 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 experiences.
4. The provisions of paragraph 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of the Contracting State, carries on business in the other Contracting State in which the royalties arise, through a

permanent establishment situated therein or performs in that other State independent personal services from a fixed base therein, and the right or property in respect of which the royalties are paid is effectively connected with the (a) such permanent establishment or fixed base or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases, the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of the State. Where, however, the person paying the royalties, whether he is a resident of the 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.
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 royalties, having regard to the use, right or information for which they are paid, exceeds 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 apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this convention.

**Article 12 of OECD Model Tax Convention**

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.



2. The terms “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 information concerning industrial, commercial or scientific experience.
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of the Contracting State , carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein or performs in that other State and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such cases , the provisions of Article 7 shall apply.
4. 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 royalties, having regard to the use, right or information for which they are paid, exceeds 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 apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this convention.

**Article 12 of US Model Convention on Royalties**

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State.
2. The term “royalties” as used in this Convention means:

- (a) any consideration for the use of, or the right to use , any copyright of literary, artistic or scientific or other work (including computer software, cinematograph films, audio or video tapes or disks, any other means of image or sound reproduction),any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, and
- (b) Gain derived from alienation of any property described in sub paragraph, (a) provided that such gain is contingent on productivity, use or disposition of the property.
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of the Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein or performs in that other State Independent personal services from a fixed base situated therein and the royalties are attributable to such permanent establishment or fixed base in such cases, the provisions of Article 7 (Business Profits) or Article 14 ( Independent Personal Services )shall apply.
4. 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 royalties, having regard to the use, right or information for which they are paid, exceeds 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 apply only to the last mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this convention.

**Extract from Indo-USA DTAA (Article 12)**

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.
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(a) ;
  - (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 payment ; 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).
6. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or Fees for included services,

being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties or Fees for included 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 royalties or Fees for included services are attributable to such permanent establishment or fixed base. In such case the provisions of article 7 (business profits) or article 15 (Independent Personal Services), as the case may be, shall apply.

- 7.(a) Royalties and Fees for included 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 resident of that State. Where, however, the person paying the royalties or Fees for included 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 liability to pay the royalties or Fees for included services was incurred, and such royalties or Fees for included services are borne by such permanent establishment or fixed base, then such royalties or Fees for included services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.
- (b) Where under sub-paragraph (a) royalties or Fees for included services do not arise in one of the Contracting States, and the royalties relate to the use of, or the right to use, the right or property, or the Fees for included services relate to services performed, in one of the Contracting States, the royalties or Fees for included services shall be deemed to arise in that Contracting State.
8. 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 royalties or Fees for included

services paid exceeds the amount which would have been paid in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

**Appeals and Objections in respect of Non-Resident Taxation: Summary**

| <b>Sl.</b> | <b>Regarding</b>  | <b>TimeLimit</b>  | <b>Relevant form (up to ITAT)</b>  | <b>Remarks</b>   |
|------------|---|---|--|--|
| 1.         | Appeal against the assessment order or order u/s 195(2) | Within thirty (30) days from the date of receipt of the order | Appeal to be made in Form No 35 before CIT (A) and Form No 36 before the ITAT. | 1. Appeal against the assessment order to be filed by the assessee under Section 246.<br>2. Appeal against the order under section 195(2) to be filed by the deductor who denies such liability of deduction of tax at source. This is mandated by Section 248. Commissioner (Appeals) to pass an order after hearing the case. He has given power to call for additional details from the assessee, the Assessing Officer and the third parties. Appeal against the order of the Commissioner (Appeals) may be made before the jurisdictional Income Tax Appellate Tribunal. The forms and other formalities are guided by Income Tax Appellate Tribunal Rules. The ITAT is the highest fact finding authority. Further appeal to the ITAT, if necessary, |

|    |   |   |                           |   |
|----|---|---|---------------------------|---|
|    |   |   |                           | may be made by the assessee or the AO only if there is any substantial question of law involved. Order against the order of the ITAT may be made before the jurisdictional High Court and similarly, to the Supreme Court may be made. An assessee may also file Writ petition before the jurisdictional High Court if it is felt that fundamental right is have been violated. |
| 2. | Review petition before the jurisdictional Director of Income Tax (International Taxation) | - | No form prescribed.       | The jurisdictional Director will pass an order after hearing the case. Generally, before passing an order, a report is called for from the Assessing Officer. No further appeal can be made against the order. An assessee cannot simultaneously file an appeal and also file a revision petition.  |
| 3. | Application before the Authority of Advance Ruling  | - | Form No 34C, 34 D or 34 E | The ruling may be sought by<br>i) A Non - Resident<br>ii) A resident in relation to a transaction with a Non Residential and consequential tax liability<br>iii) A public sector Company on any taxation issue including payment to non residents.<br>The Advance Ruling has  |

|    |   |  |          |   |
|----|---|--|----------|---|
|    |   |  |          | to be pronounced within six months from the receipt of the application. The ruling becomes binding on the Commissioner and the Income Tax Authorities subordinate to him in respect of the applicant. It is also binding on the applicant. However, the applicant may file writ petition against the order of the authority if a case for violation of fundamental right is made  |
| 4. | Objection against draft assessment order of the Assessing Office. | Within thirty days of the receipt of the draft order | Form 35A | This appeal may be by<br>a) A foreign company if any variation is made in the returned income or any transfer pricing adjustment is made on the recommendation of the TPO<br>b) Any assessee if any transfer pricing adjustment is made by the Assessing Officer on the basis of the report of the TPO. The Dispute Resolution Panel will issue appropriate directions to the Assessing Officer for the guidance of the Assessing Officer to enable him complete the Assessment. No directions will be issued |

|  |  |  |  |   |
|--|--|--|--|---|
|  |  |  |  | <p>after direction within after nine months from the end of the month in which the draft order is forwarded to the eligible assessee. The direction of the DRP is binding on the assessing officer and no appeal against such direction can be conceived of. However, the assessee may appeal to the Tribunal against the assessment order so completed in pursuance of the directions of the DRP, if considered necessary. The DRP will issue the directions after considering</p> <p>(a) draft order,<br/> (b) objections filed by the assessee,<br/> (c) evidence furnished by the assessee, and<br/> (d) report of the A. O, Valuation Officer or the TPO (if any).</p> |
|--|--|--|--|---|

### Circular No. 4 of 2009, dt 29.6.2009

Section 195 of the Income Tax Act, 1961 mandates deduction of income tax from payments made or credit given to non-residents at the rates in force. The Reserve Bank of India has also mandated that except in the case of certain personal remittances which have been specifically exempted, no remittance shall be made to a non-resident unless a no objection certificate has been obtained from the Income Tax Department. This was modified to allow such remittances without insisting on a no objection certificate from the income Tax Department, if the person making the remittance furnishes an undertaking (addressed to the Assessing Officer) accompanied by a certificate from an Accountant in a specified format. The certificate and undertaking are to be submitted (in duplicate) to the Reserve Bank of India /authorized dealers who in turn are required to forward a copy to the Assessing Officer concerned. The purpose of the undertaking and the certificate is to collect taxes at the stage when this made as it may not be possible to recover the tax at a later stage from non-residents.

2. There has been a substantial increase in foreign remittances, making the manual handling and tracking of certificates difficult. To monitor and track transactions in a timely manner, section 195 was amended vide Finance Act, 2008 to allow CBDT to prescribe rules for electronic filing of the undertaking. The format of the undertaking (Form 15CA) which is to be filed electronically and the format of the certificate of the Accountant (Form 15CB) have been notified vide Rule 37BB of the Income tax Rules, 1962.
3. The revised procedure for furnishing information regarding remittances being made to non-residents w.e.f. 1st July, 2009 is as follows:



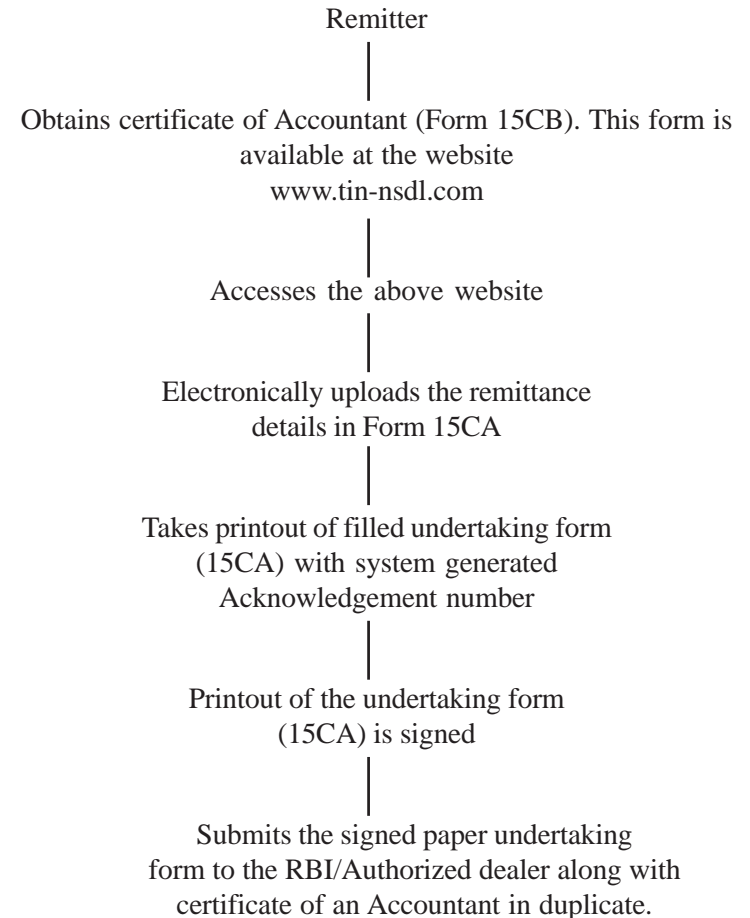
- (i) The person making the payment (remitter) will obtain a certificate from an accountant\* (other than employee) in Form 15CB.
  - (ii) The remitter will then access the website to electronically upload the remittance details to the Department in Form 15CA (undertaking). The information to be furnished in Form 15CA is to be filled using the information contained in Form 15CB (certificate).
  - (iii) The remitter will then take a print out of this filled up Form 15CA (which will bear an acknowledgement number generated by the system) and sign it. Form 15CA (undertaking) can be signed by the person authorized to sign the return of income of the remitter or a person so authorized by him in writing.
  - (iv) The duly signed Form 15CA (undertaking) and Form 15CB (certificate), will be submitted in duplicate to the Reserve Bank of India / authorized dealer. The Reserve Bank of India / authorized dealer will in turn forward a copy the certificate and undertaking to the Assessing Officer concerned.
  - (v) A remitter who has obtained a certificate from the Assessing Officer regarding the rate at or amount on which the tax is to be deducted is not required to obtain a certificate from the Accountant in Form 15CB. However, he is required to furnish information in Form 15CA (undertaking) and submit it along with a copy of the certificate from the Assessing Officer as per the procedure mentioned from S1. No. (i) to (iv) above.
  - (vi) A flow chart regarding filing of form 15CA and form 15CB is enclosed at Annexure A.
4. The Directorate General of Income tax (Systems); (www.incometaxindia.gov.in) shall specify the procedures,

formats and standards for running of the scheme as well as instructions for filling up Forms 15CA and 15CB. These forms shall be available for upload and printout at [www.tinnsdl.com](http://www.tinnsdl.com)

- 5. The Reserve Bank of India is being requested to circulate the revised procedure among all authorized dealers.

Annexure A

Flow chart of filing undertaking form u/s 195 of I T Act 1961



RBI/Authorized dealer remits the Amount

ANNEXURE 5

A copy of undertaking (Form 15 CA) & certificate  
of Accountant (Form 15CB) forwarded to  
Assessing Officer

N.B. Circular No 9 of 2009 dated 30.11.2009 being confined to the  
issue of consular receipts is not referred here.

**Circular No 774 dated 17.3.1999.**

**Subject: Issue of certificate under section 197(1)  
of the I. T. Act.**

Section 197(1) of the Act envisages that, where tax is deductible at source in terms of sections 192, 193, 194, 194A, 194D, 194I, 194K and 195 of the income tax Act and the recipient justifies the deduction of tax at any lower rate or no deduction of tax to the satisfaction of the Assessing Officer, the Assessing Officer shall issue an appropriate certificate. It has come to the notice of the Board that in certain charges a practice has developed to issue certificates under section 197(1) of the Income tax Act even after the credit or payment of amounts subject to tax deduction at source. This is not in accordance with the provisions of law. It is, therefore, clarified that the certificate issued under section 197(1) of the Income tax Act will be applicable only in respect of credit or payments, as the case may be, subject to tax deduction at source, made on or after the date of such certificate. Therefore, no certificate under section 197(1) of the Income tax Act should be issued after the amounts subject to tax deduction at source stand credited or paid, whichever is earlier. In other words, henceforth application requesting for certificate under section 197(1) should not be acted upon if submitted after credit/payment of the amount subject to tax deduction at source. However, assessee having genuine hardship in submitting such applications on time may refer to the Board for condonation of delay in terms of section 119(2)(b) of the Income tax Act.

**GOVERNMENT OF INDIA MINISTRY OF  
INDUSTRY**

**STATEMENT ON INDUSTRIAL POLICY**

New Delhi, July 24, 1991.

**POLICY OBJECTIVES**

1. Pandit Jawaharlal Nehru laid the foundations of modern India. His vision and determination have left a lasting impression on every facet of national endeavour since Independence. It is due to his initiative that India now has a strong and diversified industrial base and is a major industrial nation of the world. The goals and objectives set out for the nation by Pandit Nehru on the eve of Independence, namely, the rapid agricultural and industrial development of our country, rapid expansion of opportunities for gainful employment, progressive reduction of social and economic disparities, removal of poverty and attainment of self-reliance remain as valid today as at the time Pandit Nehru first set them out before the nation. Any industrial policy must contribute to the realization of these goals and objectives at an accelerated pace. The present statement of industrial policy is inspired by these very concerns and represents a renewed initiative towards consolidating the gains of national reconstruction at this crucial stage.
2. In 1948, immediately after Independence, Government introduced the Industrial Policy Resolution. This outlined the approach to industrial growth and development. It emphasized the importance to the economy of securing a continuous increase in production and ensuring its equitable distribution.

After the adoption of the Constitution and the socio-economic goals, the Industrial Policy was comprehensively revised and adopted in 1956. To meet new challenges, from time to time, it was modified through statements in 1973, 1977 and 1980.

3. The Industrial Policy Resolution of 1948 was followed by the Industrial Policy Resolution of 1956 which had as its objective the acceleration of the rate of economic growth and the speeding up of industrialisation as a means of achieving a socialist pattern of society. In 1956, capital was scarce and the base of entrepreneurship not strong enough. Hence, the 1956 Industrial Policy Resolution gave primacy to the role of the State to assume a predominant and direct responsibility for industrial development.
4. The Industrial Policy statement of 1973, inter alia, identified high-priority industries where investment from large industrial houses and foreign companies would be permitted.
5. The Industrial Policy Statement of 1977 laid emphasis on decentralization and on the role of small-scale, tiny and cottage industries.
6. The Industrial Policy Statement of 1980 focused attention on the need for promoting competition in the domestic market, technological upgradation and modernization. The policy laid the foundation for an increasingly competitive export based and for encouraging foreign investment in high-technology areas. This found expression in the Sixth Five Year Plan which bore the distinct stamp of Smt. Indira Gandhi. It was Smt. Indira Gandhi who emphasized the need for productivity to be the central concern in all economic and production activities.
7. These policies created a climate for rapid industrial growth in the country. Thus on the eve of the Seventh Five Year Plan, a broad-based infrastructure had been built up. Basic

industries had been established. A high degree of self-reliance in a large number of items - raw materials, intermediates, finished goods - had been achieved. New growth centres of industrial activity had emerged, as had a new generation of entrepreneurs. A large number of engineers, technicians and skilled workers had also been trained.

8. The Seventh Plan recognized the need to consolidate on these strengths and to take initiatives to prepare Indian industry to respond effectively to the emerging challenges. A number of policy and procedural changes were introduced in 1985 and 1986 under the leadership of Shri Rajiv Gandhi aimed at increasing productivity, reducing costs and improving quality. The accent was on opening the domestic market to increased competition and readying our industry to stand on its own in the face of international competition. The public sector was freed from a number of constraints and given a larger measure of autonomy. The technological and managerial modernization of industry was pursued as the key instrument for increasing productivity and improving our competitiveness in the world. The net result of all these changes was that Indian industry grew by an impressive average annual growth rate of 8.5% in the Seventh Plan period.
9. Government is pledged to launching a reinvigorated struggle for social and economic justice, to end poverty and unemployment and to build a modern, democratic, socialist, prosperous and forward-looking India. Such a society can be built if India grows as part of the world economy and not in isolation.
10. While Government will continue to follow the policy of self-reliance, there would be greater emphasis placed on building up our ability to pay for imports through our own foreign exchange earnings. Government is also committed to development and utilization of indigenous capabilities in

technology and manufacturing as well as its upgradation to world standards.

11. Government will continue to pursue a sound policy framework encompassing encouragement of entrepreneurship, development of indigenous technology through investment in research and development, bringing in new technology, dismantling of the regulatory system, development of the capital markets and increasing competitiveness for the benefit of the common man. The spread of industrialization to backward areas of the country will be actively promoted through appropriate incentives, institutions and infrastructure investments.
12. Government will provide enhanced support to the small-scale sector so that it flourishes in an environment of economic efficiency and continuous technological upgradation.
13. Foreign investment and technology collaboration will be welcomed to obtain higher technology, to increase exports and to expand the production base.
14. Government will endeavour to abolish the monopoly of any sector or any individual enterprise in any field of manufacture, except on strategic or military considerations and open all manufacturing activity to competition.
15. The Government will ensure that the public sector plays its rightful role in the evolving socio-economic scenario of the country. Government will ensure that the public sector is run on business lines as envisaged in the Industrial Policy Resolution of 1956 and would continue to innovate and lead in strategic areas of national importance. In the 1950s and 1960s, the principal instrument for controlling the commanding heights of the economy was investment in the capital of key industries. Today, the State has other instruments of intervention, particularly fiscal and monetary

instruments. The State also commands the bulk of the nation's savings. Banks and financial institutions are under State control. Where State intervention is necessary, these instruments will prove more effective and decisive.

16. Government will fully protect the interests of labour, enhance their welfare and equip them in all respects to deal with the inevitability of technological change. Government believes that no small section of society can corner the gains of growth, leaving workers to bear its pains. Labour will be made an equal partner in progress and prosperity. Workers' participation in management will be promoted. Workers' cooperatives will be encouraged to participate in packages designed to turn around sick companies. Intensive training, skill development and upgradation programmes will be launched.
17. Government will continue to visualize new horizons. The major objectives of the new industrial policy package will be to build on the gains already made, correct the distortions or weaknesses that may have crept in, maintain a sustained growth in productivity and gainful employment and attain international competitiveness. The pursuit of these objectives will be tempered by the need to preserve the environment and ensure the efficient use of available resources. All sector of industry whether small, medium or large, belonging to the public, private or cooperative sector will be encouraged to grow and improve on their past performance.
18. Government's policy will be continuity with change.
19. In pursuit of the above objectives, Government have decided to take a series of initiatives in respect of the policies relating to the following areas.
  - A. Industrial Licensing.
  - B. Foreign Investment

- C. Foreign Technology Agreements.
- D. Public Sector Policy
- E. MRTP Act.

A package for the Small and Tiny Sectors of industry is being announced separately.

#### **A. INDUSTRIAL LICENSING POLICY**

20. Industrial Licensing is governed by the Industries (Development & Regulation) Act, 1951. The Industrial Policy Resolution of 1956 identified the following three categories of industries: those that would be reserved for development in public sector, those that would be permitted for development through private enterprise with or without State participation, and those in which investment initiatives would ordinarily emanate from private entrepreneurs. Over the years, keeping in view the changing industrial scene in the country, the policy has undergone modifications. Industrial licensing policy and procedures have also been liberalized from time to time. A full realization of the industrial potential of the country calls for a continuation of this process of change.
21. In order to achieve the objectives of the strategy for the industrial sector for the 1990s and beyond it is necessary to make a number of changes in the system of industrial approvals. Major policy initiatives and procedural reforms are called for in order to actively encourage and assist Indian entrepreneurs to exploit and meet the emerging domestic and global opportunities and challenges. The bedrock of any such package of measures must be to let the entrepreneurs make investment decisions on the basis of their own commercial judgement. The attainment of technological dynamism and international competitiveness requires that enterprises must be enabled to swiftly respond to fast

changing external conditions that have become characteristic of today's industrial world. Government policy and procedures must be geared to assisting entrepreneurs in their efforts. This can be done only if the role played by the government were to be changed from that of only exercising control to one of providing help and guidance by making essential procedures fully transparent and by eliminating delays.

22. The winds of change have been with us for some time. The industrial licensing system has been gradually moving away from the concept of capacity licensing. The system of reservations for public sector undertakings has been evolving towards an ethos of greater flexibility and private sector enterprise has been gradually allowed to enter into many of these areas on a case by case basis. Further impetus must be provided to these changes which alone can push this country towards the attainment of its entrepreneurial and industrial potential. This calls for bold and imaginative decisions designed to remove restraints on capacity creation, while at the same, ensuring that over-riding national interests are not jeopardized.
23. In the above context, industrial licensing will henceforth be abolished for all industries, except those specified, irrespective of levels of investment. These specified industries (Annex-II), will continue to be subject to compulsory licensing for reasons related to security and strategic concerns, social reasons, problems related to safety and over-riding environmental issues, manufacture of products of hazardous nature and articles of elitist consumption. The exemption from licensing will be particularly helpful to the many dynamic small and medium entrepreneurs who have been unnecessarily hampered by the licensing system. As a whole the Indian economy will benefit by becoming more competitive, more efficient and modern and will take its rightful place in the world of industrial progress.

## **B. FOREIGN INVESTMENT**

24. While freeing Indian industry from official controls, opportunities for promoting foreign investments in India should also be fully exploited. In view of the significant development of India's industrial economy in the last 40 years, the general resilience, size and level of sophistication achieved, and the significant changes that have also taken place in the world industrial economy, the relationship between domestic and foreign industry needs to be much more dynamic than it has been in the past in terms of both technology and investment. Foreign investment would bring attendant advantages of technology transfer, marketing expertise, introduction of modern managerial techniques and new possibilities for promotion of exports. This is particularly necessary in the changing global scenario of industrial and economic cooperation marked by mobility of capital. The government will therefore welcome foreign investment which is in the interest of the country's industrial development.
25. In order to invite foreign investment in high priority industries, requiring large investments and advanced technology, it has been decided to provide approval for direct foreign investment upto 51% foreign equity in such industries. There shall be no bottlenecks of any kind in this process. This group of industries has generally been known as the "Appendix I Industries" and are areas in which FERA companies have already been allowed to invest on a discretionary basis. This change will go a long way in making Indian policy on foreign investment transparent. Such a framework will make it attractive for companies abroad to invest in India.
26. Promotion of exports of Indian products calls for a systematic exploration of world markets possible only through intensive and highly professional marketing activities. To the extent that expertise of this nature is not well developed so far in



India, Government will encourage foreign trading companies to assist us in our export activities. Attraction of substantial investment and access to high technology, often closely held, and to world markets, involves interaction with some of the world's largest international manufacturing and marketing firms. The Government will appoint a special board to negotiate with such firms so that we can engage in purposive negotiation with such large firms, and provide the avenues for large investments in the development of industries and technology in the national interest.

### **C. FOREIGN TECHNOLOGY AGREEMENT**

27. There is a great need for promoting an industrial environment where the acquisition of technological capability receives priority. In the fast changing world of technology the relationship between the suppliers and users of technology must be a continuous one. Such a relationship becomes difficult to achieve when the approval process includes unnecessary governmental interference on a case to case basis involving endemic delays and fostering uncertainty. The Indian entrepreneur has now come of age so that he no longer needs such bureaucratic clearances of his commercial technology relationships with foreign technology suppliers. Indian industry can scarcely be competitive with the rest of the world if it is to operate within such a regulatory environment.
28. With a view to injecting the desired level of technological dynamism in Indian industry, Government will provide automatic approval for technology agreement related to high priority industries within specified parameters. Similar facilities will be available for other industries as well if such agreements do not require the expenditure of free exchange. Indian companies will be free to negotiate the terms of technology transfer with their foreign counterparts according

to their own commercial judgement. The predictability and independence of action that this measure is providing to Indian industry will induce them to develop indigenous competence for the efficient absorption of foreign technology. Greater competitive pressure will also induce our industry to invest much more in research and development and they have been doing in the past. In order to help this process, the hiring of foreign technicians and foreign testing of indigenously developed technologies, will also not require prior clearance as prescribed so far, individually or as a part of industrial or investment approvals.

### **D. PUBLIC SECTOR POLICY**

29. The public sector has been central to our philosophy of development. In the pursuit of our development objectives, public ownership and control in critical sector of the economy has played an important role in preventing the concentration of economic power, reducing regional disparities and ensuring that planned development serves the common good.
30. The Industrial Policy Resolution of 1956 gave the public sector a strategic role in the economy. Massive investments have been made over the past four decades to build a public sector which has a commanding role in the economy. Today key sectors of the economy are dominated by mature public enterprises that have successfully expanded production, opened up new areas of technology and built up a reserve of technical competence in a number of areas.
31. After the initial exuberance of the public sector entering new areas of industrial and technical competence, a number of problems have begun to manifest themselves in many of the public enterprises. Serious problems are observed in the insufficient growth in productivity, poor project management, over-manning, lack of continuous technological up-gradation,

and inadequate attention to R&D and human resource development. In addition, public enterprises have shown a very low rate of return on the capital invested. This has inhibited their ability to re-generate themselves in terms of new investments as well as in technology development. The result is that many of the public enterprises have become a burden rather than being an asset to the Government. The original concept of the public sector has also undergone considerable dilution. The most striking example is the takeover of sick units from the private sector. This category of public sector units accounts for almost one third of the total losses of central public enterprises. Another category of public enterprises, which does not fit into the original idea of the public sector being at the commanding heights of the economy, is the plethora of public enterprises which are in the consumer goods and services sectors.

32. It is time therefore that the Government adopt a new approach to public enterprises. There must be a greater commitment to the support of public enterprises which are essential for the operation of the industrial economy. Measures must be taken to make these enterprises more growth oriented and technically dynamic. Units which may be faltering at present but are potentially viable must be restructured and given a new lease of life. The priority areas for growth of public enterprises in the future will be the following :

- Essential infrastructure goods and services.
- Exploration and exploitation of oil and mineral resources.
- Technology development and building of manufacturing capabilities in areas which are crucial in the long term development of the economy and where private sector investment is inadequate.

- Manufacture of products where strategic considerations predominate such as defence equipment.

At the same time the public sector will not be barred from entering areas not specifically reserved for it.

33. In view of these considerations, Government will review the existing portfolio of public investments with greater realism. This review will be in respect of industries based on low technology, small scale and non-strategic areas, inefficient and unproductive areas, areas with low or nil social considerations or public purpose and areas where the private sector has developed sufficient expertise and resources.

34. Government will strengthen those public enterprises which fall in the reserved areas of operation or are in high priority areas or are generating good or reasonable profits. Such enterprises will be provided a much greater degree of management autonomy through the system of memoranda of understanding. Competition will also be induced in these areas by inviting private sector participation. In the case of selected enterprises, part of Government holdings in the equity share capital of these enterprises will be disinvested in order to provide further market discipline to the performance of public enterprises. There are a large number of chronically sick public enterprises incurring heavy losses, operating in a competitive market and serve little or no public purpose. These need to be attended to. The country must be proud of the public sector that it owns and it must operate in the public interest.

**E. MONOPOLIES AND RESTRICTIVE TRADE PRACTICES ACT (MRTP ACT)**

35. The principal objectives sought to be achieved through the MRTP Act are as follows:

- i. Prevention of concentration of economic power to the common detriment, control of monopolies, and
  - ii. Prohibition of monopolistic and restrictive and unfair trade practices.
36. The MRTP Act became effective in June 1970. With the emphasis placed on productivity in the Sixth Plan, major amendments to the MRTP Act were carried out in 1982 and 1984 in order to remove impediments to industrial growth and expansion. This process of change was given a new momentum in 1985 by an increase of threshold limit of assets.
37. With the growing complexity of industrial structure and the need for achieving economies of scale for ensuring high productivity and competitive advantage in the international market, the interference of the Government through the MRTP Act in investment decisions of large companies has become deleterious in its effects on Indian industrial growth. The pre-entry scrutiny of investment decisions by so called MRTP companies will no longer be required. Instead, emphasis will be on controlling and regulating monopolistic, restrictive and unfair trade practices rather than making it necessary for the monopoly house to obtain prior approval of Central Government for expansion, establishment of new undertakings, merger, amalgamation and takeover and appointment of certain directors. The thrust of policy will be more on controlling unfair or restrictive business practices. The MRTP Act will be restructured by eliminating the legal requirement for prior governmental approval for expansion of present undertakings and establishment of new undertakings. The provisions relating to merger, amalgamation, and takeover will also be repealed. Similarly, the provisions regarding restrictions on acquisition of and transfer of shares will be appropriately incorporated in the Companies Act.

38. Simultaneously, provisions of the MRTP Act will be strengthened in order to enable the MRTP Commission to take appropriate action in respect of the monopolistic, restrictive and unfair trade practices. The newly empowered MRTP Commission will be encouraged to require investigation suo moto or on complaints received from individual consumers or classes of consumers.

## **F. DECISIONS OF GOVERNMENT**

39. In view of the considerations outlined above Government have decided to take a series of measures to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic control. These measures complement the other series of measures being taken by Government in the areas of trade policy, exchange rate management, fiscal policy, financial sector reform and overall macroeconomic management.

### **A. Industrial Licensing Policy**

- i. Industrial licensing will be abolished for all projects except for a short list of industries related to security and strategic concerns, social reasons, hazardous chemicals and overriding environmental reasons and items of elitist consumption (list attached as Annex II). Industries reserved for the small scale sector will continue to be so reserved.
- ii. Areas where security and strategic concerns predominate will continue to be reserved for the public sector (list attached as Annex I).
- iii. In projects where imported capital goods are required, automatic clearance will be given.
  - a. in cases where foreign exchange availability is ensured through foreign equity or

- b. if the CIF value of imported capital goods required is less than 25% of total value (net of taxes) of plant and equipment, upto a maximum value of Rs. 2 Crore. In view of the current difficult foreign exchange situation, this scheme (i.e. (iii) b) will come into force from April, 1992.

In other cases, imports of capital goods will require clearance from the Secretariat for Industrial Approvals (SIA) in the Department of Industrial Development according to availability of foreign exchange resources.

- iv. In locations other than cities of more than 1 million population, there will be no requirement of obtaining industrial approvals from the Central Government except for industries subject to compulsory licensing. In respect of cities with population greater than 1 million, industries other than those of a non polluting nature such as electronics, computer software and printing will be located outside 25 kms. of the periphery, except in prior designated industrial areas. A flexible location policy would be adopted in respect of such cities (with population greater than 1 million) which require industrial re-generation Zoning and Land Use Regulation and Environmental Legislation will continue to regulate industrial locations. Appropriate incentives and the design of investments in infrastructure development will be used to promote the dispersal of industry particularly to rural and backward areas and to reduce congestion in cities.
- v. The system of phased manufacturing programmes run on an administrative case by case basis will be applicable to new projects. Existing projects with such programmes will continue to be governed by them.
- vi. Existing units will be provided a new broad banding facility to enable them to produce any article without additional investment.

- vii. The exemption from licensing will apply to all substantial expansions of existing units.
- viii. The mandatory convertibility clause will no longer be applicable for term loans from the financial institutions for new projects.

#### **Procedural consequences**

- ix. All existing registration schemes (Delicensed Registration, Exempted Industries Registration, DGTD registration) will be abolished,
- x. Entrepreneurs will henceforth only be required to file an information memorandum on new projects and substantial expansions.
- xi. The lists at Annex II and Annex III will be notified in the Indian Trade Classification (Harmonized System).

#### **B. Foreign Investment**

- i. Approval will be given for direct foreign investment up to 51 percent foreign equity in high priority industries (Annex III). There shall be no bottlenecks of any kind in this process. Such clearance will be available if foreign equity covers the foreign exchange requirement for imported capital goods. Consequential amendments to the Foreign Exchange Regulation Act (1973) shall be carried out.
- ii. While the import of components, raw materials and intermediate goods, and payment of knowhow Fees and royalties will be governed by the general policy applicable to other domestic units, the payment of dividends would be monitored through the Reserve Bank of India so as to ensure that outflows on account of dividend payments are balanced by export earnings over a period of time.

- iii. Other foreign equity proposals, including proposals involving 51% foreign equity which do not meet the criteria under (I) above, will continue to need prior clearance. Foreign equity proposals need not necessarily be accompanied by foreign technology agreements.
- iv. To provide access to international markets, majority foreign equity holding upto 51% equity will be allowed for trading companies primarily engaged in export activities. While the thrust would be on export activities, such trading houses shall be at par with domestic trading and export houses in accordance with the Import Export Policy.
- v. A special Empowered Board would be constituted to negotiate with a number of large international firms and approve direct foreign investment in select areas. This would be a special programme to attract substantial investment that would provide access to high technology and world markets. The investment programmes of such firms would be considered in totality, free from pre-determined parameters or procedures.

#### **C. Foreign Technology Agreements**

- i. Automatic permission will be given for foreign technology agreements in high priority industries (Annex III) up to a lump-sum payment of Rs. 1 Crore, 5% royalty for domestic sales and 8% for exports, subject to total payment of 8% of sales over a 10 year period from date of agreement or 7 years from commencement of production. The prescribed royalty rates are net of taxes and will be calculated according to standard procedures.
- ii. In respect of industries other than those in Annex III, automatic permission will be given subject to the same guidelines as above if no free foreign exchange is required for any payments.

- iii. All other proposals will need specific approval under the general procedures in force.
- iv. No permission will be necessary for hiring of foreign technicians, foreign testing of indigenously developed technologies. Payment may be made from blanket permits or free foreign exchange according to RBI guidelines.

#### **D. Public Sector**

- i. Portfolio of public sector investments will be reviewed with a view to focus the public sector on strategic, high-tech and essential infrastructure. Whereas some reservation for the public sector is being retained there would be no bar for areas of exclusivity to be opened up to the private sector selectively. Similarly the public sector will also be allowed entry in areas not reserved for it.
- ii. Public enterprises which are chronically sick and which are unlikely to be turned around will, for the formulation of revival/rehabilitation schemes, be referred to the Board for Industrial and Financial Reconstruction (BIFR), or other similar high level institutions created for the purpose. A social security mechanism will be created to protect the interests of workers likely to be affected by such rehabilitation packages.
- iii. In order to raise resources and encourage wider public participation, a part of the government's shareholding in the public sector would be offered to mutual funds, financial institutions, general public and workers.
- iv. Boards of public sector companies would be made more professional and given greater powers.
- v. There will be a greater thrust on performance improvement through the Memoranda of understanding (MOU) systems through which managements would be granted greater autonomy and will be held accountable. Technical expertise



on the part of the Government would be upgraded to make the MOU negotiations and implementation more effective.

- vi. To facilitate a fuller discussion on performance, the MOU signed between Government and the public enterprise would be placed in Parliament. While focusing on major management issues, this would also help place matters on day to day operations of public enterprises in their correct perspective.

#### **E. MRTP Act**

- i. The MRTP Act will be amended to remove the threshold limits of assets in respect of MRTP companies and dominant undertakings. This eliminates the requirement of prior approval of Central Government for establishment of new undertakings, expansion of undertakings, merger, amalgamation and takeover and appointment of Directors under certain circumstances.
- ii. Emphasis will be placed on controlling and regulating monopolistic, restrictive and unfair trade practices. Simultaneously, the newly empowered MRTP Commission will be authorized to initiate investigations suo moto or on complaints received from individual consumers or classes of consumers in regard to monopolistic, restrictive and unfair trade practices.
- iii. Necessary comprehensive amendments will be made in the MRTP Act in this regard and for enabling the MRTP Commission to exercise punitive and compensatory powers.

#### **ANNEX I**

##### **PROPOSED LIST OF INDUSTRIES TO BE RESERVED FOR THE PUBLIC SECTOR**

1. Arms and ammunition and allied items of defence equipment, Defence aircraft and warships.
2. Atomic Energy.
3. Coal and lignite.
4. Mineral oils.
5. Mining of iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond.
6. Mining of copper, lead, zinc, tin, molybdenum and wolfram.
7. Minerals specified in the Schedule to the Atomic Energy (Control of Production and Use) Order, 1953.
8. Railway transport.

#### **ANNEX II**

##### **LIST OF INDUSTRIES IN RESPECT OF WHICH INDUSTRIAL LICENSING WILL BE COMPULSORY**

1. Coal and Lignite.
2. Petroleum (other than crude) and its distillation products.
3. Distillation and brewing of alcoholic drinks.
4. Sugar.
5. Animal fats and oils.
6. Cigars and cigarettes of tobacco and manufactured tobacco substitutes.
7. Asbestos and asbestos-based products.
8. Plywood, decorative veneers, and other wood based products such as particle board, medium density fibre board, block board.
9. Raw hides and skins, leather, chamois leather and patent leather.



10. Tanned or dressed for skins.
11. Motor cars.
12. Paper and Newsprint except bagasse-based units.
13. Electronic aerospace and defence equipment; All types.
14. Industrial explosives, including detonating fuse, safety fuse, gun powder, nitrocellulose and matches.
15. Hazardous chemicals.
16. Drugs and Pharmaceuticals (according to Drug Policy).
17. Entertainment electronics (VCRs, colour TVs, C.D. Players, Tape Recorders).
18. White Goods (Domestic Refrigerators, Domestic Dishwashing machines, Programmable Domestic Washing Machines, Microwave ovens, Air conditioners).

Note: The compulsory licensing provisions would not apply in respect of the small-scale units taking up the manufacture of any of the above items reserved for exclusive manufacture in small scale sector.

### **ANNEX III**

#### **LIST OF INDUSTRIES FOR AUTOMATIC APPROVAL OF FOREIGN TECHNOLOGY AGREEMENTS AND FOR 51% FOREIGN EQUITY APPROVALS**

##### **1. Metallurgical Industries**

- i. Ferro alloys.
- ii. Castings and forgings.
- iii. Non-ferrous metals and their alloys.
- iv. Sponge iron and pelletisation.
- v. Large diameter steel welded pipes of over 300 mm diameter and stainless steel pipes.
- vi. Pig iron.

##### **2. Boilers and Steam Generating Plants**

##### **3. Prime Movers (other than electrical generators)**

- i. Industrial turbines.
- ii. Internal combustion engines.
- iii. Alternate energy systems like solar wind etc. and equipment there for.
- iv. Gas/hydro/steam turbines upto 60 MW.

##### **4. Electrical Equipment**

- i. Equipment for transmission and distribution of electricity including power and distribution transformers, power relays, HT-switch gear synchronous condensers.
- ii. Electrical motors.
- iii. Electrical furnaces, industrial furnaces and induction heating equipment.
- iv. X-ray equipment.
- v. Electronic equipment, components including subscribers and telecommunication equipments.
- vi. Component wires for manufacture of lead-in wires.
- vii. Hydro/steam/gas generators/generating sets up to 60 MW.
- viii. Generating sets and pumping sets based on internal combustion engines.
- ix. Jelly-filled telecommunication cables.
- x. Optic fibre.
- xi. Energy efficient lamps and
- xii. Midget carbon electrodes.

**5. Transportation**

- i. Mechanized sailing vessels up to 10,000 DWT including fishing trawlers.
- ii. Ship ancillaries.
- iii. (a) Commercial vehicles, public transport vehicles including automotive commercial three wheeler jeep type vehicles, industrial locomotives.  
(b) Automotive two wheelers and three wheelers.  
(c) Automotive components/spares and ancillaries.
- iv. Shock absorbers for railway equipment and
- v. Brake system for railway stock and locomotives.

**6. Industrial Machinery**

- i. Industrial machinery and equipment.

- 7.**
- i. Machine tools and industrial robots and their controls and accessories.
  - ii. Jigs, fixtures, tools and dies of specialised types and cross land tooling, and
  - iii. Engineering production aids such as cutting and forming tools, patterns and dies and tools.

**8. Agricultural Machinery**

- i. Tractors.
- ii. Self-propelled Harvester Combines.
- iii. Rice transplanters.

**9. Earth Moving Machinery**

- i. Earth moving machinery and construction machinery and components thereof.

**10. Industrial Instruments**

- i. Indicating, recording and regulating devices for pressures, temperatures, rate of flow weights levels and the like.

**11. Scientific and Electro-medical Instruments and Laboratory Equipment.**

**12. Nitrogenous & Phosphatic Fertilizers falling under**

- i. Inorganic fertilizers under 18-Fertilizers' in the First Schedule to IDR Act, 1951.

**13. Chemicals (other than fertilizers).**

- i. Heavy organic chemicals including petrochemicals.
- ii. Heavy inorganic chemicals.
- iii. Organic fine chemicals.
- iv. Synthetic resins and plastics.
- v. Man made fibres.
- vi. Synthetic rubber.
- vii. Industrial explosives.
- viii. Technical grade insecticides, fungicides, weedicides, and the like.
- ix. Synthetic detergents
- x. Miscellaneous chemicals (for industrial use only)
  - a. Catalysts and catalyst supports.
  - b. Photographic chemicals.
  - c. Rubber chemicals.
  - d. Polyols.
  - e. Isocyanates, urethanes, etc.
  - f. Speciality chemicals for enhanced oil recovery.
  - g. Heating fluids.

- h. Coal tar distillation and product therefrom.
- i. Tonnage plants for the manufacture of industrial gases.
- j. High altitude breathing oxygen/medical oxygen.
- k. Nitrous oxide.
- l. Refrigerant gases like liquid nitrogen, carbon-dioxide etc. in large volumes.
- m. Argon and other rare gases.
- n. Alkali/acid resisting cement compound
- o. Leather chemicals and auxiliaries.

#### **14. Drugs and Pharmaceuticals**

According to Drug Policy.

- 15. i. Paper and pulp including paper products.
- ii. Industrial laminates.
- 16. i. Automobile tyres and tubes.
- ii. Rubberized heavy duty industrial beltings of all types.
- iii. Rubberized conveyor beltings.
- iv. Rubber reinforced and lined fire fighting hose pipes.
- v. High pressure braided hoses.
- vi. Engineering and industrial plastic products.

#### **17. Plate Glass**

- i. Glass shells for television tubes.
- ii. Float glass and plate glass.
- iii. H.T. insulators.
- iv. Glass fibres of all types.

#### **18. Ceramics**

- i. Ceramics for industrial uses.

#### **19. Cement Products**

- i. Portland cement.
- ii. Gypsum boards, wall boards and the like.

#### **20. High Technology Reproduction and Multiplication Equipment.**

#### **21. Carbon and Carbon Products**

- i. Graphite electrodes and anodes.
- ii. Impervious graphite blocks and sheets.

#### **22. Pretensioned High Pressure RCC Pipes.**

#### **23. Rubber Machinery**

#### **24. Printing Machinery.**

- i. Web-fed high speed off-set rotary printing machine having output of 30,000 or more impressions per hour.
- ii. Photo composing/type-setting machines.
- iii. Multi-colour sheet-fed off-set printing machines of sizes 18"x25" and above.
- iv. High speed rotograture printing machines having output of 30,000 or more impressions per hour.

#### **25. Welding Electrodes other than those for Welding Mild Steel**

#### **26. Industrial Synthetic Diamonds.**

- 27. i. Photosynthesis improvers.
- ii. Genetically modified free living symbiotics nitrogen fixer.
- iii. Pheromones.
- iv. Bio-insecticides.

#### **28. Extraction and Upgrading of Minor Oils**

**29. Pre-fabricated Building Material.****30. Soya Products**

- i. Soya texture proteins.
  - ii. Soya protein isolates.
  - iii. Soya protein concentrates.
  - iv. Other specialized products of soyabean.
  - v. Winterized and deodourised refined soyabean oil.
31. (a) Certified high yielding hybrid seeds and synthetic seeds and  
(b) Certified high yielding plantlets developed through plant tissue culture.

**32. All food processing industries other than milk food, malted foods, and flour, but excluding the items reserved for small-scale sector.****33. All items of packaging for food processing industries excluding the items reserved for small scale sector.****34. Hotels and tourism-related industry.****Circular No. 7 of 2009, dt. 22nd Oct., 2009**

Section 9 of the Income tax Act, 1961 Income Deemed to accrue or arise in India Withdrawal of Circulars No. 23 dated 23rd July, 1969, No. 163 dated 29th May, 1975 and No. 786 dated 7th February, 2000.

The Central Board of Direct Taxes had issued Circular No. 23 (hereinafter called “the Circular”) on 23rd July 1969 regarding taxability of income accruing or arising through, or from, business connection in India to a non-resident, under section 9 of the Income tax Act, 1961.

2. It is noticed that interpretation of the Circular by some of the taxpayers to claim relief is not in accordance with the provisions of section 9 of the Income tax Act, 1961 or the intention behind the issuance of the Circular.
3. Accordingly, the Central Board of Direct Taxes withdraws Circular No 23 dated 23rd July, 1969 with immediate effect.
4. Even when the Circular was in force, the Income Tax Department has argued in appeals, references and petitions that
  - (i) the Circular does not actually apply to a particular case, or
  - (ii) that the Circular cannot be interpreted to allow relief to the taxpayer which is not in accordance with the provisions of section 9 of the Income tax Act or with the intention behind the issue of the Circular.

It is clarified that the withdrawal of the Circular will in no way prejudice the aforesaid arguments which the Income tax

Department has taken, or may take, in any appeal, reference or petition.

5. The Central Board of Direct Taxes also withdraws Circulars No. 163 dated 29th May, 1975 and No. 786 dated 7th February, 2000 which provided clarification in respect of certain provisions of Circular No 23 dated 23rd July, 1969. [F. No. 500/135/2007FTDI]

**Circular: No. 152 [F. No. 484/31/74-FTD-II], dated 27-11-1974.**

**Where whole payment would not be income chargeable to tax in the hands of recipient non-resident, person responsible for paying such sum may make application for determination of appropriate portion**

1. I am directed to state that section 195 imposes a statutory obligation on any person responsible for paying to a non-resident any interest (not being “interest on security”) or any other sum (not being dividends) chargeable under the provisions of the Income-tax Act to deduct income-tax at the “rates in force”, unless he is himself liable to pay income-tax thereon as an agent. Payments to a non-resident, by way of royalty for the use of, or the right to use, any copyright (e.g., of literary, artistic or scientific work including cinematograph films or films or tapes for radio or television broadcasting), any patent, trade mark, etc., and payments for technical services rendered in India are some of the typical examples of sums chargeable under the provisions of the Income-tax Act to which the aforesaid requirement of tax deduction at source will apply. The term “rates in force” means the rates of income-tax specified in this behalf in the Finance Act of the relevant year.
2. *Where the person responsible for paying any such sum to a non-resident considers that the whole amount there of would not be income chargeable under the Income-tax Act in the case of the recipient non-resident, he may make an application under section 195(2) to the Income-tax Officer for the determination of the appropriate portion of such payment which would be taxable and in*

*respect of which tax is to be deducted under section 195(1).*

3. The object of section 195 is to ensure that the tax due from non-resident persons is secured at the earliest point of time so that there is no difficulty in collection of tax subsequently at the time of regular assessment. Failure to deduct tax at source from payment to a non-resident may result in loss of revenue as the non-resident may sometimes have no assets in India from which tax could be collected at a later stage. Tax should, therefore, be deducted in all cases where it is required to be deducted under section 195 before the payment is made to the non-resident and the tax so deducted should be paid to the credit of the Central Government as required by section 200 read with rule 30. Failure to do so would render a person liable to penalty under section 201 read with section 221, and would also constitute an offence under section 276B.

**Clarification contained in Circular No. 155, dated 21-12-1974 reiterated to ensure proper computation of tax to be deducted at source in the case of non-resident whose tax liability is to be borne by payer**

**CLARIFICATION**

1. It has come to the notice of the Board that in certain cases where payments are made to non-residents and the tax payable by the non-resident is borne by the person making the payment, the provisions of section 195 are not being followed. As a result such persons become liable to pay interest and penalty under section 201(1A) and section 221, respectively and also punishment under section 276B.
2. Board's Circular No. 155, dated 21-12-1974 outlines the method of computation of tax to be deducted at source under section 195 in the case of a non-resident, whose tax liability is to be borne by the payer and its payment to the credit of the Central Government. Paras 2, 3 and 4 of this circular are reproduced below:
  2. Where the amount payable to a non-resident is stipulated to be paid to him net of tax (i.e., where the tax payable by the non-resident is borne by the person making the payment), the income chargeable to tax in the hands of the recipient is determined by the grossing up the net of tax payment to such an amount as would, after deducting the tax on such gross amount, leave the stipulated net amount of income. Accordingly, the sum chargeable to tax in the hands of the non-resident recipient would be this grossed up amount and it is with reference to this grossed up amount that tax has



to be deducted as required by the provisions of section 195.

3. Persons responsible for paying to a non-resident person, any sums which are stipulated to be paid net of taxes should carefully note that the calculation of tax to be deducted at source as required by section 195, should be made *not* with reference to the net of tax amount payable to the non-resident but should be made with reference to the gross amount as aforesaid. Deduction of tax at source in this manner should be made every time any such payment is made to the non-resident.
4. The tax so calculated and deducted should be paid to the credit of the Central Government as required by section 200, read with rule 30 of the Income-tax Rules, 1962 and should not be withheld on the ground that the tax will, in any case, be paid by the persons making the payment ultimately when regular assessments are made in the case of non-resident payee.
3. The contents of *Board's Circular No. 155, dated 21-12-1974* are being reiterated so as to ensure that the correct amount of tax is deducted at source under section 195 at the time of payment of non-residents and after deduction, such tax is paid to the credit of the Central Government within the prescribed time.

**Circular:** No. 370 [F. No. 391/ 3/ 78-FTD], dated 3-10-1983.

#### **CLARIFICATION 2**

1. Section 195 imposes a statutory obligation on any person responsible for paying to a non-resident, any interest (not being "interest on securities") or any other sum (not being

dividends) chargeable under the provisions of the Income-tax Act, to deduct income-tax at the rates in force unless he is himself liable to pay income-tax thereon as an agent. Payments to a non-resident by way of royalty and payments for technical services rendered in India are common examples of sums chargeable under the provisions of the Income-tax Act to which the aforesaid requirement of tax deduction at source will apply. The term "rates in force" means the rates of income-tax specified in this behalf in the Finance Act of the relevant year.

2. *Where the amount payable to a non-resident is stipulated to be paid to him net of taxes (i.e., where the tax payable by the non-resident is borne by the person making the payment), the income chargeable to tax in the hands of the recipient is determined by grossing up the net of tax payment to such an amount as would after deducting the tax on such gross amount, leave the stipulated net amount of income. Accordingly, the sum chargeable to tax in the hands of the non-resident recipient would be this grossed up amount, and it is with reference to this grossed up amount that tax has to be deducted as required by the provisions of section 195.*
3. Persons responsible for paying to a non-resident person, any sums which are stipulated to be paid net of taxes should carefully note that the calculation of tax to be deducted at source as required by section 195, should be made *not* with reference to the net of tax amount payable to the non-resident but should be made with reference to the gross amount as aforesaid. Deduction of tax at source in this manner should be made every time any such payment is made to the non-resident.
4. *The tax so calculated and deducted should be paid to the credit of the Central Government as required by section 200 read with rule 30 and should not be withheld on the*

ground that the tax will, in any case, be paid by the person making the payment ultimately when regular assessments are made in the case of non-resident payee.

5. *Failure to deduct tax or, failure to pay the tax as required by the provisions of the Income-tax Act would render a person liable to penalty under section 201 read with section 221. In addition he would also be liable under section 201(1A) to pay simple interest at 12 per cent per annum on the amount of such tax from the date on which such tax was deductible to the date on which such tax is actually paid. Attention is also invited to section 276B, where in it is provided that if a person without reasonable cause or excuse fails to deduct or after deducting fails to pay the tax as required under the provisions of Chapter XVII-B, he shall be punishable with rigorous imprisonment for a term which may extend to six months, and shall also be liable to fine which shall be not less than a sum calculated at the rate of fifteen per cent per annum on the amount of such tax from the date on which such tax was deductible to the date on which such tax is actually paid.*

**Circular No 769 dated 6.8.1998.**

To All Chief Commissioners of Income-tax Subject:  
Procedure for refund of tax deducted at source under section 195

Sir,

The Board has received a number of representations for granting approval for refund of excess deduction or erroneous deduction of tax at source under section 195 of the Income-tax Act. The cases referred to the Board mainly relate to circumstances where :

- (i) after the deposit of tax deducted at source under section 195,
  - (a) the contract is cancelled and no remittance is required to be made to the foreign collaborator ;
  - (b) the remittance is duly made to the foreign collaborator, but the contract is cancelled and the foreign collaborator returns the remitted amount to the person responsible for deducting tax at source ;
  - (c) the tax deducted at source is found to be in excess of tax deductible for any other reason ;
- (ii) the tax is deducted at source under section 195 and paid in one assessment year and remittance to the foreign collaborator is made and/or returned to the Indian company following cancellation of the contract in another assessment year.

In all the cases mentioned above, where either the income does not accrue to the non-resident or excess tax has been deducted thereby resulting in a refund being due to the Indian enterprise

which deposited the tax, at present a refund can be issued only if a valid claim is made by filing a return.

2. In the absence of any statutory provision empowering the Assessing Officer to the tax deducted at source to the person who has deducted tax at source, the Assessing Officers insist on filing of the return by the person in whose case deduction was made at source. Even adjustment of the excess tax or the tax erroneously deducted under section 195 is not allowed. This has led to a lot of hardship as the non-resident in whose case the deduction has been made is either not present in the country or has no further dealings with the Indian enterprise, thus making it difficult for a return to be filed by the non-resident.
3. The matter has been considered by the Board. It has been decided that in the type of cases referred to above, a refund may be made independent of the provisions of the Income-tax Act, 1961 to the person responsible for deducting the tax at source from payments to the non-resident, after taking the prior approval of the Chief Commissioner concerned.
4. The excess tax deducted would be the difference between the actual payment made by the deductor and the tax deducted at source or that deductible. This amount should be adjusted against the existing tax liability under any of the Direct Tax Acts. After meeting such liability, the balance amount, if any, should be refunded to the person responsible for deduction of tax at source.
5. Where the tax is deducted at source and paid by the branch office of the person responsible for deduction of tax at source and the quarterly statement/annual return of tax deduction at source is filed by the branch, each branch office would be treated as a separate unit independent of the head office. After meeting any existing tax liability of such a branch, which would normally be in relation to the deduction of tax

at source, the balance amount may be refunded to the said branch office.

6. The adjustment of refund against the existing tax liability should be made in accordance with the present procedure on the subject. A separate refund voucher to the extent of such liability under each of the direct taxes should be prepared by the Income-tax Officer in favour of the "Income-tax Department" and to the bank along with the challan of the appropriate type. The amount adjusted and the balance, if any, refunded would be debitible under the sub-head "Other refunds" below the minor head "Income-tax on companies", major head "020—Corporation tax" OR below the minor head "Income-tax other than Union Emoluments", major head "021—Taxes on incomes other than corporation tax", depending upon whether the payment was originally credited to the major head "020—Corporation Tax" or to the major head "021—Taxes on Income other than Corporation Tax".
7. Since the adjustment/refund of the amount paid in excess would arise in relation to the deduction of tax at source, the recording of the particulars of adjustment/refund should be done in the quarterly statement of TDS/annual return under the signature of the Income-tax Officer at the end of the statement, i.e., below the signature of the person furnishing the statement.

Yours faithfully

(Sd.)

Surabhi Sinha

Deputy Secretary to the Government of India.

[F.No. 500/92/96-FTD]

## ANNEXURE 11

Subject: Procedure for refund of tax deducted at source under section 195 to the person deducting the tax-regarding.

The Board has issued Circular No. 769 dated 6th August, 1998, laying down procedure for refund of tax deducted under section 195, in certain situations to the person deducting the tax at source from the payment to the non-resident. After reconsideration, Circular No. 769 is revoked with immediate effect and refund to the person deducting tax at source under section 195 shall be allowed in accordance with the provisions of this circular.

2. The Board had received representations for approving grant of refund to the persons deducting tax at source under section 195 of the Income-tax Act, 1961. The cases referred to the Board mainly related to circumstances where after the deposit into Government account of tax deducted at source under section 195,
  - (a) the contract is cancelled and no remittance is made to the non-resident ;
  - (b) the remittance is duly made to the non-resident, but the contract is cancelled. In such cases, the remitted amount may have been returned to the person responsible for deducting tax at source.

In the cases mentioned above, income does not accrue to the non-resident. The amount deducted as tax under section 195 and paid to credit of the Government therefore belongs to the deductor. At present, a refund is given only on a claim being made by the non-resident with whom the transaction was intended.

3. In the type of cases referred to in sub-paragraph (a) of paragraph 2, the non-resident not having received any

payment would not apply for a refund. For cases covered by sub-paragraph (b) of paragraph 2, no claim may be made by the non-resident where he has no further dealings with the resident deductor of tax. This resident deductor is therefore put to genuine hardship as he would not be able to recover the amount deducted and deposited as tax.

4. The matter has been considered by the Board. In the type of cases referred to above, where no income has accrued to the non-resident due to cancellation of contract, the amount deposited to the credit of Government under section 195, cannot be said to be "tax". It has been decided that, this amount can be refunded, with prior approval of the Chief Commissioner concerned to the person who deducted it from the payment to the non-resident under section 195.
5. The refund being made to the person who made the payment under section 195, the Assessing Officer may after giving intimation to the deductor, adjust it against any existing tax liability of the deductor under the Income-tax Act, 1961, Wealth-tax Act, 1957 or any other direct tax law. The balance amount, if any, should be refunded to the person who made such payment under section 195. A separate refund voucher to the extent of such liability under each of the direct taxes should be prepared by the Income-tax Officer or the Assessing Officer in favour of the "Income-tax Department" and sent to the bank along with the challan of the appropriate type. The amount adjusted and the balance, if any, refunded would be debitible under the sub-head "Other Funds" below the minor head "Income-tax on companies"-major head "020-Corporation Tax" or below the minor head "Income-tax other than Union Emoluments" major head "021-Taxes on incomes other than Corporation tax" depending upon whether the payment was originally credited to the major head "020-Corporation tax" or to the major head "021-Taxes on Income other than Corporation

tax”. Since the adjustment/refund of the amount paid would arise in relation to the deduction of tax at source, the recording of the particulars of adjustment/refund, should be done in the quarterly statement of TDS/annual return under the signature of the Income-tax Officer or the Assessing Officer at the end of the statement, i.e., below the signature of the person furnishing the statement.

6. Refund to the person making payment under section 195 is being allowed as income does not accrue to the non-resident. The amount paid into the Government account in such cases, is no longer “tax”. In view of this, no interest under section 244A is admissible on refunds to be granted in accordance with this circular or on the refunds already granted in accordance with Circular No. 769.
7. A refund in terms of this circular should be granted only after obtaining an undertaking that no certificate under section 203 of the Income-tax Act has been issued to the non-resident. In cases where such a certificate has been issued, the person making the refund claim under this circular should either obtain it or should indemnify the Income-tax Department from any possible loss on account of any separate claim of refund for the same amount by the non-resident.
8. The refund as per this circular is permitted only in respect of transactions with non-residents, which have either not materialised or have been cancelled subsequently. It therefore needs to be ensured by the Assessing Officer that they disallow corresponding transaction amount, if claimed, as an expense in the case of person making refund claim.
9. It is hereby clarified that refund shall not be issued to the deductor of tax in the cases referred to in clause (i)(c) of paragraph 1. of Circular No. 769, dated 6th August, 1998,

10. The limitation for making a claim of refund under this circular shall be two years from the end of the financial year in which tax is deducted at source.

The contents of this circular may be brought to the notice of all the Assessing Officers working in your charge.

(Sd.) Rajat Bansal,

Officer on Special Duty (FTD),

[F.No. 500/92/96-FTD]

## ANNEXURE 12

### *Section 239 of the Income-tax Act, 1961 - Refunds - Procedure for refund of tax deducted at source under section 195 to the person deducting the tax - Supersession of Circular No. 790, dated 20-4-2000*

#### **CIRCULAR NO. 7/2007, DATED 23-10-2007**

The Board had issued Circular No. 790, dated 20th April, 2000, laying down the procedure for refund of tax deducted under section 195, in certain situations to the person deducting the tax at source from the payment to the non-resident. Representations have been received in the Board from taxpayers requesting that the said Circular may be amended to take into account situations where genuine claim for refund arises to the person deducting the tax at source from payment to the non-resident and it does not fall in the purview of the said Circular.

2. The cases which are being referred to the Board mainly relate to circumstances where, after the deposit into Government account of the tax deducted at source under section 195,
  - (a) the contract is cancelled and no remittance is made to the non-resident;
  - (b) the remittance is duly made to the non-resident, but the contract is cancelled. In such cases, the remitted amount has been returned to the person responsible for deducting tax at source;
  - (c) the contract is cancelled after partial execution and no remittance is made to the non-resident for the non-executed part;

- (d) the contract is cancelled after partial execution and remittance related to non-executed part is made to the non-resident. In such cases, the remitted amount has been returned to the person responsible for deducting the tax at source or no remittance is made but tax was deducted and deposited when the amount was credited to the account of the non-resident;
- (e) there occurs exemption of the remitted amount from tax either by amendment in law or by notification under the provisions of Income-tax Act, 1961;
- (f) an order is passed under section 154 or 248 or 264 of the Income-tax Act, 1961 reducing the tax deduction liability of a deductor under section 195;
- (g) there occurs deduction of tax twice from the same income by mistake;
- (h) there occurs payment of tax on account of grossing up which was not required under the provisions of the Income-tax Act, 1961;
- (i) there occurs payment of tax at a higher rate under the domestic law while a lower rate is prescribed in the relevant double taxation avoidance treaty entered into by India.

**2.1** In the cases mentioned above, income does not either accrue to the non-resident or it accrues but the excess amount in respect of which refund is claimed, is borne by the deductor. The amount deducted as tax under section 195 and paid to the credit of the Government therefore belongs to the deductor. At present, a refund is given only on a claim being made by the non-resident with whom the transaction was intended or in terms of Circular No. 790, dated 20th April, 2000.

3. In the type of cases referred to in sub-paragraph (a) of paragraph 2, the non-resident not having received any payment would not apply for a refund. For cases covered



by sub-paragraphs (b) to (i) of paragraph 2, no claim may be made by the non-resident where he has no further dealings with the resident deductor of tax or the tax is to be borne by the resident deductor. This resident deductor is, therefore, put to genuine hardship as he would not be able to recover the amount deducted and deposited as tax.

4. The matter has been considered by the Board, in the type of cases referred to above, where no income has accrued to the non-resident due to cancellation of contract or where income has accrued but no tax is due on that income or tax is due at a lesser rate, the amount deposited to the credit of Government to that extent under section 195, cannot be said to be 'tax'.
- 4.1 It has been decided that, this amount can be refunded, with prior approval of the Chief Commissioner of Income-tax or the Director General of Income-tax concerned, to the person who deducted it from the payment to the non-resident, under section 195.
5. Refund to the person making payment under section 195 is being allowed as income does not accrue to the non-resident or if the income is accruing no tax is due or tax is due at a lesser rate. The amount paid into the Government account in such cases to that extent, is no longer 'tax'. In view of this, no interest under section 244A is admissible on refunds to be granted in accordance with this circular or on the refunds already granted in accordance with Circular No. 769 or Circular No. 790.
6. In case of refund being made to the person who made the payment under section 195, the Assessing Officer may, after giving intimation to the deductor, adjust it against any existing tax liability of the deductor under the Income-tax Act, 1961, Wealth-tax Act, 1957 or any other direct tax law. The balance

amount, if any, should be refunded to the person who made such payment under section 195. A separate refund voucher to the extent of such liability under each of the direct taxes should be prepared by the Income-tax Officer or the Assessing Officer in favour of the 'Income-tax Department' and sent to the bank along with the challan of the appropriate type. The amount adjusted and the balance, if any, refunded would be debit to the major head '020- Corporation Tax' or the major head '021-Taxes on incomes other than Corporation tax' depending upon whether the payment was originally credited to the major head '020-Corporation tax' or to the major head '021-Taxes on Income other than Corporation tax'.

7. A refund in terms of this circular should be granted only after obtaining an undertaking that no certificate under section 203 of the Income-tax Act has been issued to the non-resident. In cases where such a certificate has been issued, the person making the refund claim under this circular should either obtain it or should indemnify the Income-tax Department from any possible loss on account of any separate claim of refund for the same amount by the non-resident. A refund in terms of this circular should be granted only if the deductee has not filed return of income and the time for filing of return of income has expired.
8. The refund as per this circular is, *inter alia*, permitted in respect of transactions with non-residents, which have either not materialized or have been cancelled subsequently. It, therefore, needs to be ensured by the Assessing Officer that they disallow corresponding transaction amount, if claimed, as an expense in the case of the person, being the deductor making refund claim. Besides, in all cases, the Assessing Officer should also ensure that in the case of a deductor making the claim of refund, the corresponding disallowance of expense amount representing TDS refunded is made.

9. The limitation for making a claim of refund under this circular shall be two years from the end of the financial year in which tax is deducted at source. However, all cases for claim of refund under items (c) to (i) of paragraph 2 which were pending before the issue of this circular and where the claim for refund was made after the issuance of Circular No. 790 may also be considered.
10. It has been represented to the CBDT that in Circular No. 769, dated 6th August, 1998, there was no time-limit for making a claim for refund. A time-limit of two years, for making a refund claim, was stipulated *vide* Circular No. 790, dated 20th April, 2000. Some cases covered by Circular No. 769, which were also covered by Circular No. 790, now listed in items (a) and (b) of paragraph 2 of this Circular, and filed before the issue of Circular No. 790, became time-barred because of the specification of time-limit in Circular No. 790. It is hereby clarified that such cases may also be considered for refund.
11. This Circular is issued in supersession of the Circular No. 790/2000, dated 20<sup>th</sup> April, 2000.

Extract of relevant provisions of Royalty and Fees for Technical Services DTC (Reference: Chapter ... Interpretations and Constructions

(240) “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”

- (a) the transfer of all or any rights (including the granting of a license) in respect of a patent, invention, model, design, secret formula process, trade mark or similar property
- (b) the imparting of any information concerning the working of or the use of, a patent, invention, model, design, secret formula, process, trade mark or similar property;
- (c) the use of any patent, invention, model, secret formula process, trade mark or similar property;
- (d) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
- (e) the use or right to use of any industrial, commercial or scientific equipment including any ship or aircraft but excluding the amount, item numbers 10 and 11 of Table in the Fourteenth Schedule, which is subjected to tax in accordance with the provisions of that schedule;
- (f) the use or right to use of transmission by satellite, cable, optic fibre or similar technology;
- (g) the transfer of all or any rights (including the granting of a licence) in respect of
- (i) any copyright, literary, artistic or scientific work; or

- (ii) Cinematographic films or work on films , tapes or any other means of re-production, or
- (h) the rendering of any services in connection with the activities referred to in sub clauses (a) to (g)  
284 (105) "Fees for technical services"  
(a) means any consideration including any lump sum consideration paid or payable directly or indirectly for -
  - (i) rendering of any managerial, technical or consultancy services;
  - (ii) provision of services of technical or other personnel; or
  - (iii) development and transfer of a design, drawing, plan or software, or any other service of similar nature; and
- (b) 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'.  
Extract of section 5 : Income deemed to accrue in India 5(2)
- (e) Royalty accrued from the Government or any resident;
- (f) royalty accrued from a Non-Resident, if the royalty is for the purposes of
  - (i) a business carried on by the Non-Resident in India; or
  - (ii) earning any income from any source in India ;
- (g) Fees for technical services accrued from the government or any resident;
- (h) Fees from technical services accrued from any Non - Resident, in respect of services utilized for the purposes of
  - (i) a business carried out by the non-resident in India; or
  - (ii) earning of any income from any source in India ;

**The following section 206AA shall be inserted after section 206A by the Finance (No. 2) Act, 2009, w.e.f. 1-4-2010: Requirement to furnish Permanent Account Number**

**206AA.** (1) *Notwithstanding anything contained in any other provisions of this Act, any person entitled to receive any sum or income or amount, on which tax is deductible under Chapter XVIIIB (hereafter referred to as deductee) shall furnish his Permanent Account Number to the person responsible for deducting such tax (hereafter referred to as deductor), failing which tax shall be deducted at the higher of the following rates, namely: -*

- (i) *at the rate specified in the relevant provision of this Act; or*
- (ii) *at the rate or rates in force; or*
- iii) *at the rate of twenty per cent.*
- (2) *No declaration under sub-section (1) or sub-section (1A) or sub-section (1C) of section 197A shall be valid unless the person furnishes his Permanent Account Number in such declaration.*
- (3) *In case any declaration becomes invalid under sub-section (2), the deductor shall deduct the tax at source in accordance with the provisions of sub-section (1).*
- (4) *No certificate under section 197 shall be granted unless the application made under that section contains the Permanent Account Number of the applicant.*
- (5) *The deductee shall furnish his Permanent Account Number to the deductor and both shall indicate the same*

*in all the correspondence, bills, vouchers and other documents which are sent to each other.*

**Annexure -15**

- (6) *Where the Permanent Account Number provided to the deductor is invalid or does not belong to the deductee, it shall be deemed that the deductee has not furnished his Permanent Account Number to the deductor and the provisions of sub-section (1) shall apply accordingly.*

### **Computer Software and Indirect Taxes**

In the income tax proceedings, Royalty payment and its valuation in relation to computer software is one of the most litigated and debatable issues. It may be of interest to have a look at the provisions relating to valuation of imported computer software as per the provisions of Indirect Tax Laws in India, viz, the Customs Act, the Service Tax Act and the Central Excise Act. Again, there may be further taxation in accordance with State VAT laws which are referred to here.

Customs duties are leviable on goods imported to India. In case of computer software, under the Customs Act 1962, customs duties are levied only on import of software in tangible form (i.e, on a CD or other tangible medium). Generally, following are the three modes of import of computer software

- (i) Import of complete kits comprising medium and license
- (ii) Separate import of medium and license
- (iii) Electronic download

The following customs duties are relevant in respect of software:

- (i) Basic customs duty(BCD)
- (ii) Additional Customs Duty in lieu of Excise Duty on Similar Goods( CVD)
- (iii) Additional Customs Duty in lieu of Sales Tax / VAT(SAD)

The duty rates are laid down in the Customs and Central Excise Tariff provisions. Exemptions to duties are notified by the Central Board of Excise and Customs (CBEC) from time to time.

Services in relation to IT software were brought under the ambit of service tax from May 2008. The following are taxable:

- (i) the right to use IT software for commercial exploitation
- (ii) the provision of the right to use software supplied electronically.

IT software services are said to be imported if they are provided from outside India to a person in India. The rate of service tax is 10 % (since February 24, 2009).

Traditionally, under the Customs Tariff, software kits were classified under Entry 8523, 80 20 (IT software). They were subject to a zero rate of BCD and was exempt from SAD. The applicability of CVD depended on whether the software was customized software (i.e, software which is tailor-made) or packaged software (i.e, software generally available in the market). Customized software was exempt from CVD, but packaged software attracted an 8% duty. Generally, customized software effectively attracted tax as a service, whereas packaged software was taxed as goods.

Since packaged software had been made subject to service tax, the industry bodies raised the issue of double taxation of packaged software in as much as it was taxable both under the customs duty and service tax. However, an import of software for non-commercial use (i.e, direct imports for personal use) was not liable to tax under the service tax provisions.

Following the representations from the IT industry, an amendment was brought in the year 2009 in order to reduce the burden of double taxation. Under the changed law, an exemption from CVD was granted partly. The exemption was to the extent of the consideration payable for the right to use the software for commercial exploitation. This meant that Customs Duty would be charged only with regard to the value of the tangible medium on which the software was recorded. This implied that, only the licence value attracted the charge of service tax.

Further amendments were effective from February 27, 2010. The first is that the rate of central excise duty (and therefore CVD) on IT software has been increased to 10%. The second, in line with and as an alternative to the exemption from CVD was an exemption from the whole of the applicable service tax if the entire purchase consideration has been charged to applicable customs duties. The extract of the notification is reproduced below

[TO BE PUBLISHED IN THE GAZZETE OF INDIA EXTRAORDINARY, PART II, SECTION 3, SUB-SECTION (i)]

Government of India Ministry.of Finance Department of Revenue

New Delhi, the 27thFebruary, 2010 Notification No. 02/2010 - Service Tax

G.S.R. (E).- In exercise of the powers conferred by sub-section (1) of section 93 of the Finance Act, 1994 (32 of 1994), the Central Government, on being satisfied that it is necessary in the public interest so to do, hereby exempts the taxable service as referred to under item (v) of clause (zzzze) of sub-section 105 of section 65 of the said Finance Act, for packaged or canned software, intended for single use and packed accordingly, from the whole of service tax, subject to the following conditions, namely:-

- (i) the document providing the right to use such software, by whatever name called, if any, is packed along with the software;
- (ii) the manufacturer, duplicator, or the person holding the copyright to software has paid the appropriate duties of excise on the entire amount received from the buyer; and
- (iii) the benefit under notification No. 17/2010- Central Excise, dated the 27<sup>th</sup> February, 2010 is not availed of by the manufacturer, duplicator or the person holding the copyright to software.

[F. No. 334/1/2010-TRU]

(Prashant Kumar)

Under Secretary to the Government of India

Sources: [www.internationaltaxlaw.com](http://www.internationaltaxlaw.com) & official site of the Customs and Central Excise Department, [www.cbec.gov.in](http://www.cbec.gov.in)

**Annexure 16**

**Extracts from the Indian Copy Right Act, 1957**

**I. Meaning of the Term ‘Copyright’ under the Indian Copyright Act.**

Section 14 of the Indian copyright act allows the following acts : (a) in the case of a literary, dramatic or musical work, not being a computer programme -

- (i) To reproduce the work in any material form including the storing of it in any medium by electronic means ;
- (ii) To issue copies of the work to the public not being copies already in circulation to perform the work in public, or communicate it to the public,
- (iii) To make any cinematographic film or sound recording in respect of the work,
- (iv) To make any translation of the work;
- (v) To make any adaptation of the work;
- (vi) To do, in relation to translation or an adaptation of the work, any of the acts specified in relation to the work specified in sub-clauses (i) to (vi)

(b) in the case of a computer programme -

- (i) to do any of the acts specified in clause (a);
- (ii) to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme [as amended by the Copyright (Amendment Act, 1999]



Provided that such commercial rental does not apply in respect of computer programmes where the programme itself is not the essential object of the rental.

## II. Infringement of Copyright

Section 51 of the Indian Copyright Act defines what is meant by ‘infringement of a copy right’.

Section 52(1)(aa) of the Act clarifies that certain acts do not constitute infringements of a copyright, including,

(aa) the making of copies or adaptation of a computer programme by the lawful possessor of a copy of such computer programme, from such copy-

(i) in order to utilize the computer programme for the purposes for which it was supplied ;

(ii) to make back-up copies purely as a temporary protection against loss , destruction or damage in order only to utilize the computer programme for the purposes for which it was supplied;

(ab) the doing of any act necessary to obtain information essential for operating interoperability of an independently created computer programme with other programmes by a lawful possessor of a computer programme provided that such information is not otherwise readily available, (ad) the making of copies or adaptation of the computer programme from a personally legally obtained copy for no commercial personal use.

## Acknowledgements

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|---|---|--|
| 1 | <b>Indian Double Taxation Agreements &amp; Tax Laws</b>   | D.P.Mittal (Volume 1-3) Taxmann Publication                    |
| 2 | <b>Basic International Taxation</b>   | Roy Rohtagi Taxmann Publication                                |
| 3 | <b>International Taxation- A compendium (Revised 2008)</b>  | The Chamber of Tax Consultants                                 |
| 4 | <b>Income Tax Guide for Non - Residents and Indian Nationals Abroad</b>   | Directorate of Income Tax (PR,PP & OL)                         |
| 5 | <b>Handbook on Advance Rulings</b>  | -do-   |
| 6 | <b>Taxation of Non Residents (Frequently Asked Questions onTDS, Royalty Income And Taxation of Expatriates)</b> | Bombay Chartered Accountant’s Society                          |
|   | <b>Presumptive Taxation of Non - Residents</b>  | Suresh V.Swamy Company Law Institute of India Pvt Ltd, Chennai |

In addition to the above references, material available in the Internet has been widely used. Reference of the source has been given in the relevant chapter itself. Without attempting an exhaustive list, particular mention may be made of the following two Articles:

|   |                    |  |
|---|--------------------|--|
| 1 | www.wikepdia.com   | International Taxation Case Laws - Compiled by CA Kirit Dedhia   |
| 2 | www.itatonline.org | Royalties and Fees for Technical Services in International Trade Article by M.M. Chishty & Sumangala A chakalabbi , University College of Law, Dharwad |

The articles published in the monthly journal of International Taxation by the Taxmann Publication and online articles on [www.taxindiaonline.com](http://www.taxindiaonline.com) have also been found useful.



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