ICAI releases Royalty & FTS Technical Guide; Discusses implications of Software Royalty ruling, MFN Circular

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The Committee on International Taxation of the Institute of Chartered Accountants of India releases fifth edition of Technical Guide on Royalty and Fees for Technical Services, covering all the recent notifications, judicial updates and reporting requirements; Takes into consideration recent developments such as SC ruling in Engineering Analysis and CBDT Circular on MFN clause and its impact on determining taxability of royalty/FTS; Provides illustrative list of income qualifying as royalty/FTS as well as income excluded from definition of royalty/FTS, relying on catena of rulings; The Technical Guide also highlights peculiarities in definition of royalty/FTS in specific DTAAs entered into by India with a diagrammatic explanation for characterisation of income as royalty/FTS, tests enshrined under the Act and classification of software payments to determine the taxability

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Key Takeaways:

1. While examining taxability under the provisions of the Act, it is necessary to examine taxability under the provisions of the applicable DTAA, so as to facilitate optimization of the overall tax position in India.

2. The deeming provisions governing the scope of total income (i.e., “deemed to accrue or arise” in India) should be examined only if the income is not actually “accruing” or “arising” in India, relying on Calcutta HC ruling in Oriental Co. Ltd.

3. Following aspects would have to be cumulatively kept in perspective, while examining characterization of income as “royalty”:

- Ownership/possession of licence rights to the underlying asset with respect to which the payment is made and retention of ownership/ licence rights therein;
- Purpose for which the payment is made;
- Facts of the case;
- Substance of the arrangement
- Classification of the payment under the Import Policy;
- Characterization of the payment in the RBI approval, if any;
- Characterization of the payment in the Government approval, if any.

4. Likewise, the following aspects should be looked at in respect of payments of software:

- EULA: The terms of the End user license Agreement (EULA) should be examined. Based on the EULA, characterization of Income is to be gauged. - whether Payment is for transfer or use of copyright
- Substance of the arrangement: Nature of transfer, terms and conditions of license agreement, use /right to use the software have to be looked into. Mode of transfer and technology used are not the decisive factors.

5. Explanation 4 inserted vide Finance Act, 2012 with retrospective effect from Jun 1, 1976 clarified that irrespective of the medium through which the transfer of all or any right for the use or right to use computer software (including granting of license) would take place, the same would be treated as royalty. However, SC in Engineering Analysis held that ‘Explanation 4 cannot apply to any right for the use of or the right to use computer software even before the term “computer software” was inserted in the statute ‘. Likewise, SC also held that it was not logical to insert Explanation 6 defining the term to include transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, and optic fibre or by any other similar technology, retrospectively.

6. Payment for software is covered as part of royalty in only 5 treaties namely Morocco, Russia, Turkmenistan, Malaysia and Tobago. Therefore, it will still be a good case to argue that in case of off-the-shelf or standardized software, payments in the nature of royalty are not chargeable to tax in India, except where it is specifically covered in the tax treaty.

7. The definition of “royalty” under the OECD Model Convention is narrower when compared with the UN Model Convention. In view of the retrospective amendments made to section 9(1)(vi) by the Finance Act 2012 with regard to royalty, widening the scope thereof, the narrower definition as contained in the tax treaties would come to the rescue of the taxpayer.

8. MFN clauses are not identical in all DTAAs in respect of FTS/FIS. In some, the benefit is extended only to the rates and not to scope, while in some both are covered. In the first case, only the concessional rate would be available and “make available” clause will not be granted. On the other hand, if both rate and scope are covered by the MFN clause then both will be available. Hence, the MFN clause must be carefully read.

9. As per the recent Pune ITAT ruling in GRI Renewable Industries, Protocol is an integral part of a DTAA, there is no need for a separate notification. Such opinion is contrary to CBDT Circular No.3 of 2022 wherein it was clarified that a separate notification should be issued by India, importing the benefits of the second treaty into the treaty with the first State, as required by the provisions of sub-section (1) of Section 90, for availing benefits of MFN clause.

10. Before taking help of the MFN clause the DTAA should be carefully studied to ascertain that there is no restriction. Similarly, the date of availability of the MFN should be examined carefully to be sure that there is no restriction regarding dates from which the beneficial DTAA would be available.

11. In most of the DTAAs when it comes to 'service PE', any service which can be covered by the FTS or FIS clause in the respective tax treaty are specifically excluded as these clauses refer to "*the furnishing of services, other than included services as defined in Article 12 (Royalties and fees for included services), within a Contracting State by an enterprise through employees or other personnel*" and "*the furnishing of services including managerial services, other than those taxable under Article 13 (Royalties and fees for technical services), within a Contracting State by an enterprise though employees or other personne*l" respectively. There is no such exclusion clause in the PE article dealing with construction, installation and assembly activities, including supervision activities relating thereto.

12. A general principle that must be kept in perspective is that provisions of sections 9(1)(vi) and 9(1)(vii) deal specifically with royalty and FTS, respectively. Accordingly, given that a specific provision would override a generic provision, section 9(1)(i) should not be applied in circumstances where a particular income qualifies as “royalty” or “FTS” but is not taxable by virtue of any specific exclusion.

13. The Income Tax Act provides a mechanism for computation of royalty and FTS income depending on whether the non-resident has PE or not. In case the non-resident does not have PE in India, the royalty / FTS would be taxable on gross basis (i.e., without allowing any deduction for expenses incurred) @ 10% plus applicable surcharge and cess as per Section 115A. Where the non-resident has PE in India, Royalty / FTS received by a non-resident from the Government / Indian concern under agreements entered after 31st March, 2003 and effectively connected to a PE / fixed place of profession in India would be computed under the head “business income” and would be taxed @ 40% as per Section 44DA.

14. Similar to the treatment provided in section 115A, royalty or FTS / FIS not attributable to a PE in India of the non-resident recipient would be taxable on gross basis (as per relevant provisions of the DTAA). Most DTAAs India has entered into provide for a tax rate in the range of 10-15%. In such a scenario, the assessee has an option to apply the tax rate prescribed in the applicable DTAA or section 115A of the Act, whichever is more beneficial to it.

15. Where the DTAA does not contain provision recognising FTS/FIS separately, the scope of taxing the said income as FTS cannot be expended by importing the said provision from the Income-tax Act when it is excluded under the DTAA. In such cases, based on past judicial precedents, a view which is commonly adopted is that any sum paid (which is otherwise in the nature of FTS / FIS) to a tax resident of these countries should not be liable to tax in India in absence of a PE in India of the non-resident recipient (to

which such income is attributable). Such payment should also not be taxable as other income since when a particular nature of income is dealt with in the treaty provisions, and its taxability fails because of conditions precedent to such taxability and as specified in that provision are not satisfied, that is the end of the road for taxability in the source state.