ROYALTIES AND FEES FOR TECHNICAL SERVICES IN INTERNATIONAL TRADE

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Introduction

International trade is the exchange of capital, goods, and services across international borders or territories. While international trade has been present throughout much of history, its economic, social, and political importance has been in the rise in recent centuries. Industrialization, advance transportation, globalization, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. International trade is a major source of economic revenue for any nation that is considered a world power.

I. Bird’s eye view

In the late 1980’s, the more progressive developing countries, particularly in Latin America, began to give up their isolationist policies and to loosen the controls over trade and investment.

Today they are trying to attract large sources of new capital for investment, new technologies, new manufacturing techniques and business know-how, improve training for their labour force and organizational and managerial expertise. Some countries are lowering taxes on royalties paid to foreign companies under licensing agreements for modern technology and technical assistance. Government “Red-tape” is being cut allowing a faster and easier flow of paper work through government bureaucracies, and Government agencies are applying laws and regulations to foreign firms in a fairer and more consistent manner.¹

India still has some of the most severe restrictions in the world. They have high tariffs and quotas on imports, import licensing requirements a ban on the import of practically all consumer goods and strict control over the import of commodities. Since 1976, India has applied the rule of taxation of royalties and fees for technical services. This has resulted into more foreign collaboration and Indian importers asking for advanced technology and services from other source countries.

II. Meaning of Royalty and Fees for Technical Services

Royalty- A payment made to an author on invention for each copy of a work or article sold under a copyright or patent.² In the Income Tax Act, 1961 (hereinafter referred to as the Act), royalty is not specifically defined its provided in the Explanation 2 of section 9(1)(vi). The meaning of royalty is not to be restricted to what is mentioned in the Act, even Double Taxation Avoidance Agreements (hereinafter referred to as DTAA) entered with other nations are inclusive of the definition of royalty.

Madras High court in the case of CIT v. Neyveli Lignite Corp.Ltd.³ has expressed that the term cannontes “royalty” which normally connotes the payment made by a person who has exclusive right over a thing for allowing another to make use of that thing which may be either physical of intellectual property or thing.

³ CIT V. Neyveli Lignite Corp. Ltd. 243 ITR 459
Fees for technical services— fee mean a charge for labour or services, especially for professional services. In the Act meaning for fees for technical services is provided in Explanation 2 of Section 9(1)(vi). Only services of technical nature are taxable as fees for technical services are not personal, what is technical has to be determined from facts and circumstances of every transaction. Most of the DTAA’s do not provide for the meaning of fees for technical services specifically but it is either included under the term royalty or distinguished from the term personal services.

III. Basis of Charge

According to Sec. 4 of the Act, income tax shall be chargeable on every person whose income in previous year is taxable in the assessment year at any rate or rates. Income tax at that rate or those rates shall be charged for that year in accordance with, and subject to provisions of the Act. Sec 4 charges every person in respect of his ‘total income’, and Sec. 5 defines the gamut of total income. The principal underlying Sec. 5 is to take the changeability of income depending upon the locality of accrual of receipt.

IV. Rate of Taxation

Sec. 115A deals with determination of tax on dividends, royalties and fees for technical services in the case of foreign companies. In certain cases this section provides, a special rate of tax on dividends, royalties and fees for technical services, interest, incomes from units and computer software fees received by non-resident or non-corporate assesses or foreign company.

The tax rates mentioned in the Act will not be applicable where a lower rate of tax is prescribed under an agreement for the avoidance of double taxation entered into by the Central Government, under S. 90 with any other country or payment made in pursuance of the agreement approved by the Central Government.

V. Payment of Income Tax by Assesses in Different Form

A. RESIDENT:

A resident who pays for the use of royalty does not directly come under the purview of taxation under Sec. 115A of the Act. The resident merely has to deduct tax at source for such payments made by him to a non-resident. Sec. 195 provides hat when any person pays to a non-resident, not being a company or to a foreign company ant interest or any other sum chargeable under the provisions of the Act, not being income chargeable under the head ‘salaries’, shall at the time of such payment by any mode deduct income tax thereon at the rates in force.

B. NON-RESIDENT:

Royalty or fees for technical services paid to a non-resident is always taxable and more so under Sec. 9(1)(vi) & (vii) in respect of its use for business purposes carried on in India. DTAA would also entitle royalty as mentioned in respective DTAA’s to be taxed in the country where it arises.

Sec. 44DA provides that the income by way of royalty or fees for technical services receives from government or an Indian concern in pursuance of an agreement made by a non-resident (not being a company) or a foreign company with government of the Indian concern after 31st March, 2003, shall be computed under the head “profits and gains of business of professions” in accordance with the provisions of the Act.

C. FOREIGN COMPANY:

Sec 44D(a) of the Act provides that in case of foreign company, the deductions admissible under section 28 to 44C of the Act in computing the income by way of royalty or fees

4 Supra note 2
5 Kanga Palkhivala; Vyas, The Law and Practice of Income tax, 9th Ed. (2004), LexisNexis Butterworths
for technical services received from an Indian concern is pursuance of an agreement made with the Indian concern before 1st April, 1976, shall not exceed 20 percent of the gross amount of such income. Where such agreement is made after 31st March, 1976, Sec. 44D(b) provides that no deduction will be allowed in respect of any expenditure or allowance under any of the said sections in computing such income.

VI. A Magnified View over the Intellectual Property Right- Software’s

There are three categories of software that may be distributed, namely, specialist bespoke programs, general commercial software and mass marketed software. The first is an unlikely candidate for distribution, while commercial programs with a general application are more suited for distribution. Mass marketed software has been beleaguered by the greater number of problems and is subjected to the same affliction that plagues the music industry- copyright infringement on commercial scale. For the purposes of copyright law, computer programs are treated as “literary works”.

Notwithstanding all of these hazards, the efficiently and technical advances underlying licensing makes it a rapidly expanding and highly profitable form of doing business abroad. It is, however, an endeavour that must be pursued cautiously.

One of the questions faced by the foreign companies which supply the Intellectual property or advanced technology such as software is whether the payment made thereof takes the character of ‘royalties’ or leads to business profits?

In view of *Tata Consultancy Services v. State of A.P* 6, computer software put in the medium of disk are “goods” and its purchase constitutes the “Purchase” of a tangible asset and the assessee becomes the “owner” thereof, though the content on such medium is intangible asset. The fact that the computer software is obtained by way of “ownership” or on “license” is not determinative. The functional test is more important. If the tests of ownership and enduring benefit are satisfied, the question whether expenditure incurred on computer software is capital or revenue has to be seen from the point of view of its utility to a businessman and how important an economic or functional role it plays in his business. 7

Under the Act, right to use software is ‘royalty’ irrespective of the fact that it is on a CD. Treating payments to acquire software as royalties could imply more revenues for the tax department in India. However, revenues may not be guaranteed for the tax department if they are treated as business profits due to ‘permanent establishment’ issues for multinational software companies.

The high-profile Microsoft case, involving about Rs. 700 crore, is an example of differing interpretations on the “characterization” of the payments made for software. Transfer of all or any rights of software including granting of a license in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property would fall under the term royalty. Thus, to conclude, only those transactions wherein there is a transfer of all or any rights of the computer software would fall within the definition of royalty under explanation 2 of Sec 9(1) (vi) and not those transactions of commercial nature.

VII. Interpretation- is it Complex?

Controversies relating to international taxation are about the provisions of domestic law, the treaties and the conventions concerning double taxation avoidance. Tax treaties may give rise to various tax disputes, which domestic tax forums and courts have to deal with. The main problem before such courts would be that there are often no precedents to be followed, since international tax law is still in its infancy. Most of the cases are being decided keeping the law aside and depending upon facts and circumstances of the case.

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6 Tata Consultancy Services v. State of AP 271 ITR 401 (SC)
7 Amway India Enterprises v. DCIT 301 ITR 1 (Delhi)
In interpreting a section in a taxing statute, according to Lord Simons, “the question is not at what transactions the section is according to some alleged general purpose aimed, but what transaction its language according to its natural meaning fairly and squarely hits.”

It is, therefore, not the function of a court of law to give to words a strained and unnatural meaning to cover loopholes through which the evasion tax-payer may find escape or to tax transactions which, had the legislature thought of then, would have been covered by appropriate words. If there is any ambiguity in respect of the subject of the tax, person liable to pay the tax and the rate at which the tax is levied, and such ambiguity is not removable by reasonable construction then there will be no tax in law till the defect is removed by legislature.

VIII. Conclusion

With respect to the Act, Sec 115A where it provides concessional rate of tax for royalty where the agreement is in respect of industrial policy or approved by the Central Government. It is an option available that if the subject is not included in the industrial policy then the person who makes such payment shall try and get the approval of the Central Government for a concessional rate of tax. The situation is not very clear on what basis the Government grants approval for such agreement, whether it is being based on industrial policy or it is a matter administrative policy. And when such payments are made by the Government itself the rule is not much clear whether it has to be presumed that it is approved by the Central Government.

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8 St. Aubhya (LM) v. A.G. (1951) 2 ALL ER 473
9 IRC v. Wolfson (1949) 1 ALL ER 865
10 State of Kerala v. Alex George (2005) 1 SCC 299