ANNEXURE 1

TAXATION OF NON-RESIDENTS

In this chapter, the law as applicable to non-residents is discussed keeping in view the provisions of Indian Income tax Act, the double tax avoidance agreements (“DTA”) and the rulings of the courts as well as the Authority for Advance Rulings (“AAR”).

The main provisions relevant to taxation of non-residents are sections 4, 5, 6 and 9 of the Indian Income tax Act, 1961 (“the Act”). While section 4 is the charging section, section 5 outlines the scope of total income for various categories of tax payers depending on their residential status. Broadly speaking, the world income of a resident is taxed while for the non-resident only income accruing or arising in India or received in India or deemed to accrue or arise or received in India is taxed.

1. Residential Status

The residential status of a person is defined in section 6 of the Act. Different criteria are prescribed for determining the residential status depending on the category of ‘persons’. For individuals, stay within India is the determining factor. A company is a resident in India in any previous year if it is an Indian company ie a company formed and registered under Companies Act 1956 (“CoAct”) or any other law earlier in force in any part of India or if during that year the control and management of its affairs is situated **wholly** in India (may include a company formed and registered under the law of any other country). Every person other than an individual and a company is said to be non-resident in India in any previous year if during that year the control and management of its affairs is situated **wholly outside** India.

2. Income chargeable to tax

Section 4(1) of Income tax Act, 1922 (“IT Act 1922”) provided that subject to the provisions of the said Act, the total income of any previous year of any person who was not resident in the taxable territories during such year would include all income, profits and gains from whatever source derived which:

(a) were received or were deemed to be received in the taxable territories (British India) in such year by or on behalf of such person, or

(b) accrued or arose or were deemed to accrue or arise to him in the taxable territories during such year.

Section 5(2) of the Act, incorporates the above provision without any change, except that the words “taxable territories” have been replaced by the term “India”. Explanation to section 5 of the Act, clarifies that income accruing or arising outside India shall not be deemed to be received in India by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Thus, income from whatever source derived but received or deemed to be received in India by or on behalf of a non-resident, even if such income accrued outside India, is taxed in the hands of the non- resident under the Act. The Act does not clarify in what circumstances income could be deemed to have been received in India by a non-resident. However, the Supreme Court held, in the case of **Raghava Reddy Vs. CIT (44 ITR 720)**, that commission credited by Indian exporter of mica to Japan, in the account of a Japanese firm, for the orders secured by it in Japan, would be deemed to have been received in India on the day it was credited to the Japanese firm's account following the instructions given by that firm.

Taxation of income on received or deemed received basis is no longer possible in majority of cases as the Government of India has entered into DTAs with a large number of countries. The provisions of DTA's override the provisions of Act. However, in the event the provisions in the Act are more beneficial to the taxpayer, the same would apply in light of the provisions of Section 90(2) of the Act, Central Board of Direct Taxes' ("CBDT") circular No. 333 dated April 2, 1982 and the decision in the case of **Vishakhapatnam Port Trust (144 TR 146).**

3. Income accruing or arising in India

Section 42(1) of IT Act 1922 and section 9 of the Act define the phrase "Income deemed to accrue or arise in India". Clause (i) of section 9(1) of the Act, substantially reiterates the provisions of section 42(1) of IT Act 1922. Clauses (ii), (iii) and (iv) were introduced when the Act came into force. Clauses (v) to (vii) were inserted vide Finance Act 1976 with effect from April 1, 1976. For the purposes of the discussion of the Committee, clauses (i), (vi) and (vii) of section 9(1) of the Act have been examined.

Clause (i) of section 9(1) of the Act provides that all income accruing or arising whether directly or indirectly through or from any ‘business connection’ in India, or through or from any property in India or through or from any asset or source of income in India, etc shall be deemed to accrue or arise in India. Clause (a) of the explanation to the clause clarifies that only such part of income as is reasonably attributable to the operations carried out in India will be deemed to accrue or arise in India. Clause (b) of the explanation states that no income shall be deemed to accrue or arise in India through or from operations, which are confined to purchase of goods in India for the purposes of export. Clause (c) of the explanation also clarifies that in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing news papers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

The scope of income accruing or arising in India has been discussed in various decisions of High Courts and the Supreme Court. It has been observed by courts that it is impossible to lay down any general test to determine the place where profits accrue. The place of formation of the contract or the place where the contract is carried out are some of the criteria that have been/ are kept in perspective while determining where profits accrue.

When the business comprises buying and selling goods, profits accrue as a general rule where the property in the goods passes to the purchaser. In a loan transaction, the decisive factor would be the place where the money is actually lent irrespective of where it came from or the actual place of use of the money.

It will be however pertinent to refer to decision of Supreme Court in the case of **Performing Right Society Ltd Vs CIT (106 ITR 11**). In the said case, the assessee, Performing Right Society Ltd was a company incorporated in England and having its registered office in London. The society was an association of composers, authors and publishers of copyright of musical work established to grant permission for public performance or broadcast of copyright music. The society collected royalties for issuing license which granted such permission and distributed royalties received from the license to the members of the society, namely the composers, authors, music publishers and other persons having interest in the copyright. In 1953, the society entered into a license agreement with All India Radio (“AIR”), granting AIR the license to broadcast in India all musical works in the repertoire of the society, provided that AIR being the licensee provided the society in London with a list of all musical work broadcasted by it in each week during the term of the license from each of the licensee's main stations and the external service stations. Further, AIR had to pay the society a license fee at the rate of two pounds per hour of broadcast of western music from each of the licensee's main and external service stations. Such annual payment was to be made by AIR to the society in London. It was pleaded before the Court that since the agreement between society and the licensee was executed in England and royalties were payable in England, income arising from this agreement is not liable to tax in India. The Supreme Court held that although the society was a non-resident company and it received the income out of the agreement which was executed in England and not in India, the income undoubtedly accrued or arose in India. The court pointed out that determination of whether a certain income accrued or arose in India within the meaning of section 5(2) of the Act is a question of fact which should be examined and decided upon in light of common sense and plain thinking. The Supreme Court approved the decisions of lower authorities that it is a matter of fact that the income derived from broadcast of copyright music from the stations of AIR arose in India. The Court further pointed out that even if the source of income was the agreement entered into in England, the question as to the source of the income was not relevant because section 5(2) provides that all income ‘from whatever source derived’ is to be included in the total income of the non-resident assessee, if the income accrued or arose in India during the relevant year. The provisions of section 9 which deem income to accrue or arise in India, though actually accruing elsewhere, would not be relevant since income in the instant case has in fact accrued in India.

4. Business Connection

The scope of ‘business connection’ in India, in terms of the provisions of sections 42(1) and 42(3) of IT Act 1922, was subject matter of judicial interpretation in a large number of cases. These decisions have no validity for the residents of the countries with whom DTAs have been executed. However, some of these decisions have been discussed to outline the evolution of taxation of income of non-residents in India.

In connection with the above, it is pertinent to note the judgement in the case of **Hira Mills Ltd Vs ITO (14 ITR 417)**. A company, manufacturing cloth at Ujjain in the Gwalior state sent cloth to Kanpur in British India for being marketed in British India through brokers, who were not its employees and who were not canvassing orders exclusively for the assessee. Offers of purchase sent by brokers to Gwalior were not in any special form. They were either accepted or rejected by the company at Ujjain but contracts were all for delivery "F.O.R. Ujjain". Goods were generally consigned to "self" at the place of destination and the merchants took delivery by paying the invoiced price plus freight and insurance to a broker or brokers in British India and in exchange receiving an endorsed railway receipt. The Allahabad High Court held that there was no ‘business connection’ in British India and the income could not, therefore, be deemed to have accrued or arisen to the tax payer of Ujjain in British India within the meaning of section 42(1) of the IT Act, 1922.

The first important decision of the Supreme Court was in the case of **Anglo French Textile Company Ltd Vs CIT (23 ITR 101).** A company, incorporated in the United Kingdom, owned a spinning and weaving mill at Pondicherry in French India. It had appointed another limited company in Madras as its constituted agent for the purpose of its business in British India. Under the agreement, the agent had full powers in connection with the assessee's business in the matter of purchasing stock, signing bills and other negotiable instruments and receipts and settling, compounding or compromising any claim by or against the British company. During the relevant year, no sales of yarn or cloth manufactured by the company were effected in British India. However, all purchases of cotton required for the mill at Pondicherry, were made by the agent in British India. No purchases were made through any other agency. The agents exercised their judgement and skill and purchased such qualities and quantities of cotton at such prices as they in their experience considered most advantageous to the interests of the British company.

The Supreme Court held that an isolated transaction between a non-resident and a resident in British India without any course of dealings such as might fairly be described as a ‘business connection’, does not attract the application of section 42. But, when there is a continuity of business relationship between the person in British India who helps to make the profits and the person outside British India who receives or realises the profits, such relationship does constitute a ‘business connection’. On the issue, whether only acts of purchase of cotton in British India would constitute 'operations' to which profits can be reasonably attributed, the Court held that “it is not every business activity of a manufacturer that comes within the expression 'operation' to which the provisions of section 42(3) are attracted. These provisions have no application unless according to the known and accepted business notions and usages the particular activity is regarded as a well defined business operation. Activities which are not well defined or are of a casual or isolated character would not ordinarily fall within the ambit of this rule”. The court held, relying on past decisions, that the acts of regular and systematic purchases of goods within British India (for manufacture or sale outside British India) would constitute profit bearing operations for the purpose of section 42(3) of the IT Act, 1922. In a case where all that may be known is that a few transactions of purchases of raw materials have taken place in British India, it could not ordinarily be said that the isolated acts were in their nature of ‘operations’ within the meaning of that expression as envisaged in section 42(3). As mentioned earlier in the Act, an explanation has been introduced [clause (b) of explanation below section 9(1)(i)] which provides that in the case of a non-resident no income shall be deemed to ‘accrue or arise in India’ through or from operations which are confined to the purchase of goods in India for the purpose of export. This explanation nullifies the above decision of Supreme Court.

The second important decision was in the case of **CIT Vs RD Agarwala and Co (56 ITR 20).** In the above case, the assessee company canvassed orders from dealers in Amritsar for the supply of goods and communicated them to certain non-resident exporters. The assessee company had no authority to accept the orders on behalf of the non-residents. The orders were accepted by the non-residents, price was received by them and delivery was also given outside the taxable territories (British India). No operations such as procuring raw materials or manufacture of finished goods took place within the taxable territories. The assessee company was entitled to commission on these sales. The Supreme Court held that the activity of the assessee in procuring orders was not as agents of the non-residents in respect of sale of goods manufactured by the non-resident. Their activities led to the making of offers by merchants in the taxable territories to purchase goods manufactured by the non-resident which the latter was not obliged to accept. The expression ‘business connection’ postulates a real and intimate relation between trading activity carried on outside the taxation territories and trading activity within the territories, which contributes to the earning of income by the non-resident in his trading activity. The Court observed that “the expression 'business connection' undoubtedly means something more than business”. A ‘business connection’ in section 42 involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains. It predicates an element of continuity between the business of the non-resident and the activity in the taxable territories. A stray or isolated transaction is normally not to be regarded as a ‘business connection’. ‘Business connection’ may take several forms: it may include carrying on a part of the main business or activity incidental to the main business of the non-resident through an agent, or it may merely be a relation between the business of the non-resident and the activity in the taxable territories which facilitates or assists the carrying on of that business. In each case, the question whether there is a ‘business connection’ from or through which income, profits or gains arise or accrue to a non-resident must be determined based on the facts and circumstances of the case.

The above decision was again followed by Supreme Court in the case of **CIT Vs TIM Sales Ltd (l66 ITR 93)**, wherein an Indian company acted as a marketing organisation in India for several foreign companies. The Supreme Court based on the following facts held that there was no ‘business connection’ between the foreign companies and the Indian company:

- procuring of raw materials and manufacture of finished goods took place outside taxable territories;
- contracts for sale of goods were entered into and price was received by the non-residents outside the taxable territories;

- delivery was also made outside the taxable territories;
- the orders which were sent from India were accepted by the non-residents in London;
- intimation of such acceptance was communicated either to the Indian company or to the Indian customers and the orders became binding contracts only after the same were accepted in this manner; and
- the Indian company had no authority to accept any offers on behalf of any of the foreign companies.

In contradiction to the above, is the ruling by the AAR in **P No 8 of 1995 (223 ITR 416).** The facts of the case are as follows:

A company incorporated in Switzerland, who was in the business of trading in goods and commodities on an international basis intended to trade with India. For this purpose, it had proposed to set up a subsidiary company in India to provide consultancy services from India to the foreign company for use outside India. The proposed services were as follows:

(a) secretarial and clerical assistance to complete documentation of tenders, contracts and subsequent documentation required to enable Indian customers, who had purchased commodities from the Swiss company overseas to obtain delivery of the said commodity on its arrival in India; and

(b) assist in responding to global tenders floated by Indian organisations which entailed providing information and submitting tenders within the parameters laid down by the Swiss company.

The foreign company was to retain the Indian subsidiary as a consultant on a non-exclusive basis for a year (to be automatically renewed) and the Indian subsidiary was at all times to act on instructions from the applicant (ie the Swiss company) and would not have any authority to accept orders on behalf of or bind the applicant. The AAR after referring to the decision of Supreme Court in the case of RD Agarwala held that a ‘business connection’ could be held to exist based on the terms of the agreement in question. It was pointed out that although the agreement in question was initially for one year and liable to termination at short notice, it was also envisaged that unless terminated it should continue indefinitely, automatically renewed at the end of each year. Though, the subsidiary was not required to render services exclusively to the foreign company, it was bound to render all services for the applicant as stipulated in the agreement. There was a term of ‘confidentiality’ included in the agreements, which also placed considerable restrictions on the capability of the subsidiary in rendering like services to other parties. The scope of work in the proposed agreements included not only clerical and secretarial assistance, but supply of information in respect of global tenders, by the subsidiary to the applicant and vice versa, signing and submitting of tenders on behalf of the applicant, although stated to be within the parameters fixed by the applicant, negotiating the terms of the tender with the tendering authorities, again within the parameters laid down by the applicant; and follow up of the tenders and finally signing the agreements. The business activity or the business relationship between the applicant and the subsidiary would not be based on any stray transaction but would be a continuous process in respect of a series of purchase and sale transactions undertaken by the foreign company in India and in all such transactions, the subsidiary would execute the work as stated in the agreement. The AAR held that such an intimate and continuous relationship would constitute a 'business connection' for the purposes of section 9(1)(i) of the Act.

The issue whether supply of technical information and knowhow regarding manufacture of products by a foreign company to an Indian company would imply a 'business connection' in India arose before Supreme Court in the case of **Carborendum Co Vs CIT (108 ITR 335)**. In the said case, a foreign company, which specialised in the manufacture of bonded abrasive and coated abrasive products, entered into an agreement with an Indian company for rendering the following technical and knowhow services to the Indian company:

(a) furnishing technical information and knowhow with respect to manufacture of bonded abrasive and coated abrasive products;

(b) providing technical management including factory design and lay out, plant and equipment production, purchase of materials, manufacturing specifications and quality of products;

(c) furnishing comprehensive technical information of all developments in the manufacture of special products;

(d) providing the Indian company with a resident factory manager for starting the plant and superintending its operations during its initial production stages as also other technical personnel necessary for operation of the plant; and

(e) training Indian personnel to replace foreign technical personnel as quickly as possible.

In lieu of these services, the foreign company was to receive an annual fee equal to three percent of the net sale proceeds of the products manufactured by the Indian company every year. The Supreme Court held that the foreign company had furnished technical information from abroad by post and it was a service rendered outside India. The act of utilising the information in India was not relevant. The activities of the foreign personnel lent or deputed by the foreign company did not amount to a business activity carried on by the foreign corporation in India. It had made the services of the foreign personnel available to the Indian company outside India and the Indian company employed these personnel as their own employees and they worked under the direct control of the Indian company and the services were rendered by the foreign company wholly outside India. The Supreme Court also pointed out that even assuming that there was any ‘business connection’ between the earning of technical services fee and the affairs of the Indian company, no part of the activity or operation could be said to have been carried on by the foreign company in India. The Court observed that in order to bring the income of a non-resident within the deeming provisions of section 42(1) of the IT Act 1922, it is up to Revenue authority to prove that some of the operations were carried out in India in respect of which the income is sought to be assessed. The Court finally held that the technical service fees earned by the foreign company did not accrue or arise in India nor could it be deemed to have accrued or arisen in India. It would be pertinent to note that this decision is in respect of an assessment year prior to April 1, 1976. From April 1, 1976, clauses (vi) & (vii) of section 9(1) have been introduced whereby any ‘royalty’ or ‘technical services fees’ received by a foreign company from an Indian company would be deemed to accrue or arise in India, if the technical knowhow, technical services etc provided by the foreign company is utilised by the Indian company in its business in India. The place where the services are rendered is no longer relevant.

5. Attribution of Income

Rule 10 of Income tax Rules, 1962 (“Rules”) provides for the determination of income which can be reasonably attributed to the operations carried out in India, when, in the case of a business of a non-resident, some operations are carried out in India and some outside India. Under this rule when the Revenue authority is of the opinion that the actual amount of income accruing or arising to any non-resident person whether directly or indirectly, cannot be definitely ascertained, such income may be taken as:

(i) such percentage of the turnover so accruing or arising as the Revenue authority may consider to be reasonable;

(ii) an amount which bears the same proportion to the total profits and gains of the business of such person (such profits and gains being computed in accordance with the provisions of the Act) as the receipts so accruing or arising bear to the total receipts of the business; or

(iii) in such other manner as the Revenue authority may deem suitable.

Prior to the above rule, for determination of income of a non-resident attributable to Indian operations was introduced, the Supreme Court in the case of **CIT Vs Ahmedbhai Umarbhai & Co (18 ITR 472)** had dealt with the issue of apportionment of profits accruing in British India and native princely states. In the said case, the taxpayer being a firm resident in British India, carried on the business of manufacture and sale of groundnut oil and had a mill at Raichur in the Hyderabad State, where oil was manufactured. This oil was partly sold in Bombay. The issue was whether a part of the profits derived from sale of oil in Bombay in British India could be attributed to the manufacturing operations at Raichur or whether the total profits arose only at the time of sale of the oil in Bombay and no part of the profits could be said to have accrued at the place of manufacturing operations in Raichur. The Court explained that on sale of goods, the assessee received money. While the receipt of the price was thus in Bombay, it is an entirely different thing to say that therefore the whole profits of manufacture and sale arose in Bombay. This argument overlooks the distinction between accruing or arising on the one hand and receipt on the other. The question of profits has to be determined not on receipt of the price of each lot sold by the assessee but as a result of all operations undertaken in connection with the manufacture and sale of oil during the accounting year. The court held that in such situations profits could be apportioned between the manufacturing and trading activities, particularly when the assessee carried on the business of manufacturing and trading together and a portion of the profits should be treated as manufacturing profit resulting from the manufacturing operations carried out at Raichur and such profit should be taken to have accrued or arisen in Raichur, outside British India.

6. Analysis of provisions relating to Permanent establishement ("PE") and royalties and fees for technical services under the DTA and Act

Under these agreements, the jurisdiction to levy income-tax on non-resident assessees is clearly separated and earmarked on accrual basis between the respective countries. Section 90(2) of the

Act provides that the provisions of the agreements would prevail over the provisions of the Act, to the extent the same are more beneficial to the non-resident. These agreements generally follow the United Nations Model ("UN Model"), and lay down rules of accrual of income of different categories. The provisions of Act are no longer relevant, unless they are more beneficial to the non-residents. However, with regard to residents of countries, with which, there is no agreement, the provisions of Act would apply.

Although all DTAs entered into by the Government of India are based on the UN Model, there are minor variations of the terms from agreement to agreement. For determining place of accrual of an income of a non-resident, it is necessary to see the exact terms of the agreement with the relevant country. As an illustration, the provisions of the India–US DTA are discussed in detail in the following paragraphs.

6.1 Definition of PE under the India-US DTA

Article 4 of this India-US DTA provides that "resident of a contracting state" means any person who under the laws of that state is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature, but does not include any person who is liable to tax in that state in only in respect of income from sources in that state. The article further provides that where by reason of the above provisions, an individual is a resident of both contracting states, then his residential status would be determined on the basis of the location of his permanent home, center of vital interests, habitual abode or his nationality (in the above order of preference). Where a company is found to be resident of both the states, such company shall be considered to be outside the scope of the agreement. Article 7 of the India-US DTA provides that the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a PE situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only to the extent the same are attributable to that (a) PE; (b) sales in the other state of goods or merchandise of the same or similar kind as those sold through that PE; or (c) other business activities carried on in the other state of the same or similar kind as those affected through that PE.

PE has been defined in Article 5 of the India-US DTA as follows:

(1) For the purposes of this convention, the term "PE" means a fixed place of business through which the business of an enterprise is wholly or partly carried on, and

(2) "PE" includes a place of management; a branch; an office; a factory; a workshop; a mine; an oil or gas well; a quarry; or any other place of extraction of natural resources; a warehouse in relation to a person providing storage facilities for others; a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on; a store or premises used as a sales outlet. It also includes an installation or structure used for the exploration or exploitation of natural resources, but only if same is used for a period of more than 120 days in any twelve month period and a building site or construction, installation or assembly project or supervision activities in connection therewith where such site, project or activities (together with other such sites, projects or activities if any) continue for a period or more than 120 days in any twelve month period. Furnishing of services, other than included services as defined in Article 12 (royalty and fees for included services) within a contracting state by an enterprise through employees or other personnel, is also included in the definition of PE provided:

i) activities of that nature continue within that state for a period or periods aggregating to more than 90 days within any twelve month period, or

(ii) the services are performed within that state for a related enterprise (within the meaning of paragraph 1 of Article 9 - Associated Enterprise).

Paragraph 3 of Article 5 however clarifies that the term "PE" shall be deemed not to include any one or more of the following:

(a) Use of facilities solely for the purpose of storage, display or occasional delivery of goods or merchandise belonging to the enterprise;

(b) Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage display or occasional delivery;

(c) Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) Maintenance of fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise;

(f) Maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research; or

(g) For activities, which are preparatory or auxiliary in nature

Paragraphs 4 and 5 of Article 5 outlines situations in which the agents of a non-resident operating in a state can be held to constitute a PE. Paragraph 4 provides that where a person, other than an agent of independent status, is acting in a contracting state on behalf of an enterprise of the other contracting state, that enterprise shall be deemed to have a PE in the first mentioned state, if:

(a) he has and habitually exercises in the first mentioned state an authority to conclude contracts on behalf of the enterprise unless his activities are limited to those operations (activities outlined in paragraph 3), which even if exercised through a fixed place of business would not constitute a PE;

(b) has no such authority but habitually maintains in the first mentioned state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that state on behalf of the enterprise have contributed to the sale of goods or merchandise; or

(c) he habitually secures orders in the first mentioned state wholly or almost wholly for the enterprise.

Paragraph 5 however provides that an enterprise of a contracting state shall not be deemed to have a PE in the other contracting state merely because it carries on business in that other state through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. It is however clarified that when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered to be an agent of independent status.

It is also clarified in paragraph 6 that the fact that a company which is a resident of a contracting state and controls or is controlled by a company, which is a resident of the other contracting state or which carries on business in that other state (whether through a PE or otherwise) shall not by itself constitute either company a PE of the other.

6.2 Rulings of the AAR in connection with constitution of PE

In the following paragraphs, the Committee has discussed some of the important decisions of the AAR on the issue whether in a given situation a foreign enterprise can be said to have a PE in India.

In the case of **Tekniskil (Sendirian) Berhard Vs CIT (222 ITR 551)** the facts were that a Malaysian company had entered into a contract with another foreign company having its registered office in Korea. As per the agreement, the company incorporated in Korea had been awarded certain contracts in the territory of Bombay High by ONGC of India. For carrying out the above work, it needed the services of skilled labour and requested the

Malaysian company to supply the skilled labour required to carry out the above work. The workmen were to function under the directions and supervision of the Korean company, which could disqualify and demobilize any of the workers in the event that their services were not satisfactory based on certain criteria provided for in the contract. The Malaysian company was to pay salary, insurance premium, charges for mobilization to Bombay and demobilization from Bombay, all taxes, provide medical treatment at onshore sites including transportation by helicopter, arrange for application for visa and passport to enter India and work permit and security passes issued by the Korean company. In consideration for supply of skilled labour, the Malaysian company received fees from the Korean company. In its application to the AAR, the Malaysian company claimed that the fees received from the Korean company were exempt from Indian tax under the provisions of the DTA between India and Malaysia. It contended that the fees derived by it from the Korean company arose out of a business of supply of skilled labour carried on by it and such business income cannot be taxed in India unless it found that the Malyasian company constitutes a PE and the profits are attributable to such PE. The AAR held that the income derived by the Malaysian company under the agreement could be described as 'fees for technical services', but since such fees were earned in the course of business of supply of skilled labour, it constituted 'business income'. Such income is covered by Article 7 of the DTA and the receipts can be taxed only if these are attributable to a PE of the Malaysian company in India (there was no separate provision for taxation of royalty or technical services fees in the particular DTA). The AAR held that the activity of the Malaysian company of recruiting foreign labourers abroad and supplying them to another foreign company in India would not constitute a PE. It could have been so if the Malaysian company had maintained in India:

(a) recruitment office for labour;

(b) an establishment to import training to or conduct tests and examination for the labourers or to issue qualification certificates;

(c) an organisation making arrangement for reception, boarding and lodging of the labourers, before they were taken over by the other company; or

(d) establishment to look after the salary payment, insurance, health and medical treatment of the labourers.

In another case **P No 11 of 1995 (228 ITR 55)**, a company incorporated under the laws of Singapore entered into two contracts with another foreign company for providing services related to burial of pipe lines offshore India, near a oil well in the Bombay High. The job to be executed was in the nature of turnkey sub-contract, the main contract from ONGC had been obtained by another company. For execution of the above contract, all marine vessels, personnel and equipment were to be provided by the Singapore company. The duration of the two contracts were 7 and 39 days respectively. The AAR pointed out that under the DTA with Singapore a PE would include a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. Further, a building site or construction, installation or assembly project would also constitute a PE only if it were to continue for a period in excess of 183 days in a fiscal year. Since the Singapore company had only worked on the oil or gas well and the oil well was not owned or operated by it, it’s case would be covered under the latter situation ie clause relating to building site etc, and there will be a PE in India, only if the duration of the installation or assembly project exceeds 183 days in a fiscal year, which is not the case here. The AAR held that since the Singapore company did not have a PE in India, its Indian income would not be taxable, even though such activities took place within Indian territory and profits therefrom would have been chargeable to tax under the Act, in the absence of the DTA.

In the case of **Brown & Root Incorporated Vs CIT (237 ITR 156),** a company incorporated and existing under the laws of USA had entered into a sub-contract with a Korean company in relation to the installation of a gas pipeline between two oil platforms in Bombay High. The job was carried out by mobilising an eight point mooring vessel and a test support vessel. The job was completed in 39 days from the date of commencement. On issue of taxability of the amount received by the foreign company for execution of the contract in India, the Revenue authority contended that the foreign company had carried out the whole work from the above vessels which had all the modern office facilities. The Revenue authority therefore contended that the foreign company had a place of management, or a workshop in India during the period of contract or alternately an oil or gas well. The AAR held that the activity of installation of the pipeline could not be brought under other clauses of Article 5(2) of the DTA between India and USA. A specific provision will override a general one and the foreign company is entitled to invoke the provision most beneficial to it, under the DTA or the Act. Accordingly, the AAR held that the activity would fall under clause (k) of Article 5(2) of the DTA namely a building site or construction, installation or assembly project and the foreign company will not have a PE in India because the site or project did not continue for more than 120 days. In the absence of a PE, the business profits earned by the foreign company were not taxable in India.

In the case of **Horizontal Drilling International SA Vs CIT (237 ITR 142)**, a French company was awarded a contract by the Gas Authority of India Ltd for installation of gas pipelines crossing under Yamuna river utilising optic fiber cables, for a lump sum consideration. The work was completed in less than a month's time. The French company contended before the AAR that it was not liable to tax in India on the amount received under the contract. On the other hand, the Revenue authorities contended that the amount would be taxable in India as ‘fees for technical services’ under Article 13(4) of the DTA between India and France. The AAR held that Article 13(4) of the said DTA defines ‘fees for technical services’ to mean payments of any kind to any person in consideration for services of a managerial, technical or consultancy nature. This is a very comprehensive provision and covers all cases where such services are rendered by one of the parties to a contract and payments in consideration thereof is made by the other. A limitation of some kind or the other has to be read into the terms of what otherwise would be a very wide definition. Paragraph 6 of Article 13 excludes the application of Article 13 to cases where the consideration would normally and more appropriately be assessable under other specific articles, such as Article 7 (business profits) or Article 15 (independent personal services). Article 7 brings within the ambit of Indian tax business profits arising to a non- resident, but only where the non-resident has a PE in India. The expression PE has been defined in Article 5 and it includes "a building site or construction, installation or assembly project, but only where such site or project continues for a period of more than six months". In the above situation, it would be appropriate to read the two articles harmoniously and include within it the definition in Article 13(4) in respect of payments made in consideration for services and correlated thereto and excluding from its purview the payments made in consideration for the execution of a construction or installation project or the like which is referred to in Article 5(3).

The issue as to when the agent of a non-resident operating in India, would represent a PE was examined by the AAR in two cases. In the first case, **TVM Ltd Vs CIT (237 ITR 230)**, the company was incorporated in Mauritius with five shareholders. It was engaged in the business of development, operation, marketing, sale and distribution of television programmes and broadcasting of a television channel. To operate a channel, the operator required certain software. A company known as TVI Ltd incorporated in India was engaged in the production of such software. TVI Ltd had the same shareholders or group of shareholders as TVM Ltd with identical proportions of share holding. The directors of the two companies were however different. There were no common directors and it was claimed that the management of TVI Ltd was entirely independent of that of TVM Ltd. TVM Ltd was desirous of "selling air time" on the channel to parties in India (advertisers). It therefore proposed to enter into a solicitation agreement for such sale with TVI Ltd where the latter would also be responsible for remitting the advertisement revenues so collected to TVM Ltd and be entitled to a commission for the services rendered by it in this connection. The issue that arose was whether the business profits earned by TVM Ltd from sale of air time on the television channel broadcast in India would be deemed to accrue or arise and liable to tax in India and whether the agent appointed by TVM Ltd to solicit orders from purchasers of air time and pass on such orders to TVM Ltd for acceptance could be construed to be a PE of TVM Ltd in India. The AAR held that TVM Ltd had been incorporated with view to operate a TV channel in Mauritius, since it was considered expedient that such a company should be incorporated in a country neutral to all the parties concerned and from where the broadcasting was permitted. Mauritius emerged as the most appropriate choice, since it had the facility of up-linking of TV programmes and other advantages, while the Indian law did not permit up-linking of TV programmes from India. The AAR accepted that these were satisfactory considerations for the incorporating TVM Ltd in Mauritius and held that the application for advance ruling did not raise a question, that was related to a transaction that was designed to avoid income tax. The AAR also held that TVI Ltd could not be held to constitute a PE of TVM Ltd merely on the ground that the shareholding of the two companies was identical. The point to be examined is the relation between TVM Ltd and TVI Ltd. Article 5(5) of the DTA between India and Mauritius negates the existence of a PE, where the enterprise of one contracting state carries on business in the other contracting state through a broker, general commission agent or any other agent of independent status. When an agent does not qualify as independent agent as provided for in Article 5 of the DTA, the issue regarding PE has to be resolved in terms of para 4 of Article 5. Under para 4, a agent who is not of independent status can be deemed to constitute a PE only if he cannot act independently in the matter of concluding contracts on behalf of the principal on his own free will and without control of the latter. What paras (4) and (5) of Article 5 of the DTA refer to are not theoretical powers or the legal amplitude of activities that can be carried on by the company but the factual position as to what it is the company actually doing at present. Para 4 has two expressions: 'has' and 'habitually exercises' (an authority to conclude contracts on behalf of the enterprise in question). The expression 'habitually exercises' has reference to a systematic course of conduct on the part of the agent. If despite the specific provision of the soliciting agreement, it is found as a matter of fact that TVI Ltd is habitually concluding contracts on behalf of TVM Ltd without any protest or dissent, perhaps it could be presumed either that the relevant provisions of the agency agreement are a dead letter ignored by the parties or that the principal has agreed implicitly to TVI exercising such powers notwithstanding the terms of the contract. If such a situation is found to exist, then perhaps it could be said that TVI Ltd constitutes a PE for TVM Ltd despite the clauses of the contract contained in the agreement between the two. The AAR also held that the 'business profits' earned by TVM Ltd through TVI Ltd are profits deemed to accrue or arise in India under section 9(1)(i). However, they would be taxable in India by virtue of Article 7 of the DTA, if only TVI Ltd and not TVM Ltd is shown to exercise generally the power to conclude the advertisement contracts for the sale of air time. The AAR also referred to the Circular No.742 dated May 2, 1996, issued by the CBDT in the matter of taxation of foreign telecasting companies, wherein it was provided that it would be fair and reasonable if the taxable (Indian) income of the foreign telecasting companies which are not having any branch office or PE in India is computed by adopting a presumptive profit of 10 percent of the gross receipts (excluding the amount retained by the adverting agent and the Indian agent of the non-resident foreign telecasting company as their commission/ charges) meant for remittance abroad, or the income returned by such companies whichever is higher. The AAR held that these guidelines are only general in character and it is open to assessees to accept them only if they are beneficial to them. However, to the extent these guidelines purport to extend the applicability of the presumptive rate of profits to cases where the foreign telecasting company has no PE in India, it can not be treated as laying down the correct position in law.

In the second case, **Al Nisr Publishing (239 ITR 879)**, a firm in Dubai in UAE was engaged in the business of publishing a daily English language newspaper called "Gulf News". In order to solicit orders for advertisement from Indian advertisers in the newspaper, the firm entered into an agency agreement with an Indian company under which the Indian company was appointed as an exclusive agent for the solicitation of advertisements from recognised advertisement agencies and national advertisers in India for the newspaper. Under the agreement, the Indian company agreed that it would not enter into any contract or accept any order on behalf of the firm or act on its behalf or bind or attempt to bind it in any way. The Indian company was also required to inform all prospective advertisers that all orders are subject to acceptance by the non-resident firm. The agreement empowered the non-resident firm to accept orders for advertisement and the right to refuse to accept any order at its own discretion. The Indian company was entitled to commission at 30 percent, which was to be deducted out of the charges collected prior to remittance to the non-resident firm. As per the agreement, the Indian company was free to act as advertising agent in India for other overseas news papers, magazines and publications. The AAR ruled that paragraph 4 of Article 5 of the DTA between India and UAE is applicable only in a case where the person who acts as agent for the non-resident is not an agent of independent status within the meaning of paragraph 5. The Indian company was an agent for receiving advertisement and collecting advertisement revenues on behalf of the non-resident firm in India. But the agency was not exclusive. The memorandum of association of the Indian company permitted it to carry on business as advertising agents and in exercise of that power and in the course of such business, it had entered into contracts with several foreign newspapers to act as their representative for collection of advertisements in India. Thus, the Indian company though an agent of the non-resident firm from UAE, was an agent of independent status within the meaning of paragraph 5 of Article 5 of the DTA between India and UAE. Accordingly, the terms of paragraph 4 of Article 5 were not applicable to the instant case, since the paragraph applies only in cases where the person carrying on business for the non-resident principal is an agent who is not of independent status. The AAR held that even if a 'business connection' could be said to exist between the non-resident firm and the Indian company and profits arising out of operations in India of such business connection were taxable under section 9 of the Act, the non-resident firm could take benefit under the provisions of Article 7 of DTA read with Article 5. Business profits arising through such business connection are exempt where no PE exists.

In recent times, an interesting issue has arisen as to whether foreign enterprises who carry on the business of rendering certain on-line services to customers in another country, without having any human presence in the country where customers are located, can be said to have a PE in the said country. The issue arose before a Revenue authority in the case of a foreign enterprise, which carries on the business of providing the services of Computerised Reservation System (“CRS”) for airline booking. The business of a CRS Company is to make airline ticket reservations on behalf of the participating airlines that enter into contractual relationships with the CRS company. For this purpose, the CRS Company maintains CRS on the host computer in a foreign country. The participating airlines provide the necessary information viz display of schedules and fares, building of connections and flight travel liability status which is displayed on the CRS. The CRS Company sets up marketing companies in different countries and also provides the equipment necessary for connectivity to its host computers, to the marketing companies in these countries. The marketing companies in turn provide such equipment to select local travel agents to enable them access the centralised reservation system of the CRS Company from their local computers and make airline bookings for their respective clients. For such services, the CRS Company receives a booking fee from the concerned airlines. The assessing authority sought to tax the booking fees which originated in India by contending that such fees were accruing or arising in India through a PE. According to the Revenue authority, all the activities regarding booking of airlines tickets by the travel agents in India were done from the computers of the travel agents connected to the host computer with the help of the equipment provided by the CRS Company. The CRS Company had placed such equipment in India at the disposal of the marketing companies, so as to enable local travel agents could use the service for airline bookings. The Revenue authority concluded that in accordance with the OECD Commentary on Model Tax Convention, the equipment owned by the CRS Company and kept in India would constitute PE of the CRS Company in India. Also, it was observed that the marketing company in India had to act as the exclusive marketing agent of the CRS Company and could not act for any business rival of the CRS Company. Accordingly, it was held that since the activities of the marketing company are wholly and exclusively devoted to the CRS Company, the same would constitute a dependent agent of the CRS Company in India and hence constitute a PE of the CRS Company in India. The booking fees received by the CRS Company from various airlines, in respect of bookings made by travel agents from India accrued to the CRS Company, were held to be through the PE in India and was taxable under the Act. The order passed by the Revenue authority has been upheld at the first appellate stage.

6.3 Rules for computation of business profits of a PE

Article 7 of the DTA between India and USA lays down rules for computation of business income of a non-resident arising in India through a PE maintained by it. Paragraph 2 of Article 7 provides that where an enterprise of a contracting state carries on business in the other contracting state through a PE situated therein, there shall in each contracting state be attributed to that PE, the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same and similar conditions and dealing wholly at arm's length with the enterprise of which it is a PE and other enterprises controlling, controlled by or subject to the same common control as that enterprise. In any case where the correct amount of profits attributable to a PE is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the PE may be estimated on a reasonable basis. Paragraph 3 provides that while determining the profits of a PE there shall be allowed as deductions, expenses which are incurred for the purposes of the business of the PE including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the PE), whether incurred in the state in which the PE is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that state. However, no such deduction shall be allowed in respect of amounts if any paid (otherwise than towards reimbursement of actual expenses) by the PE to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents, knowhow or other rights or by way of commission or other charges for specific services performed, or for management or except in the case of banking enterprises, by way of interest on moneys lent to the PE. In determining the profits of the PE, no account shall be taken of amounts charged (otherwise than towards reimbursement of actual expenses), by the PE to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights or by way of commission or other charges for specific services performed or for management or except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

Paragraph 5 provides that profits to be attributed to the PE shall include only the profits derived from the assets and activities of the PE.

Paragraph 6 provides that where profits include items of income which are dealt with separately in other articles of the agreement, then the provisions of those articles shall not be affected by the provisions of this article.

Paragraph 7 defines the term "business profits" to mean income derived from any trade or business including income from the furnishing of services, other than included services as defined in Article 12 (royalties and fees for included services) and including income from the rental of tangible personal property other than property described in paragraph 3(b) of Article 12 (royalties and fees for included services).

The provisions of Articles 5 and 7 of the India–US DTA are based on the UN Model and are similar to those contained in the OECD Model Tax Convention. The DTAs entered with UK, France, Germany, South Africa, Australia, Canada, Japan, China, Sweden, Switzerland, etc are also on the same lines.

As stated earlier in paragraph 3 of the Article 7, allowance of deductions for expenses, which are incurred for the purpose of earning profits, has to be in accordance with the provisions of and subject to the limitations of the taxation laws of that state, in which the PE is situated. Section 44C of the Act provides that in the case of an assessee being a non-resident, no allowance shall be made in computing the income chargeable under the head 'profits and gains of business or profession' in respect of so much of the expenditure that is in the nature of head office expenditure (meaning executive and general administrative expenditure incurred by the assessee outside India) in excess of 5 percent of the adjusted total income computed in accordance with the provisions of the Act without giving effect to certain allowances in respect of unabsorbed depreciation allowance, investment allowance, etc or so much of the head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India, whichever is lower. Section 44D provides that in the case of an assessee, being a foreign company, no deduction in respect of any expenditure or allowance shall be allowed under any of the said sections in computing income by way of ‘royalty’ or ‘fees for technical services’ received from Government of India or an Indian concern in pursuance of an agreement made by the foreign company with Government or with the Indian concern after March 31, 1976.

Section 115A(1)(b) provides that where the total income of a foreign company includes any income by way of ‘royalty’ or ‘fees for technical services’ received from Indian Government or an Indian concern in pursuance of an agreement made by the foreign company with the Government or the Indian concern and where such agreement is with an Indian concern, the agreement is approved by the Central Government or where it relates to a matter included in the Industrial Policy of the Government of India and the agreement is in accordance with that policy, then the income from royalty and fees for technical services (gross receipts without deduction of any expenditure or allowance under the provisions of the Act) would be subjected to tax at the rate of 20 percent (in respect of agreements executed after May 31, 1997). Sub-section (1A) of Section 115A however provides that where the royalty is in consideration for the transfer of all or any rights (including the granting of a licence) in respect of copy right in any book to an Indian concern or in respect of any computer software to a person resident in India, it would be sufficient if import of such book or computer software is permitted under an Open General License under the Import Trade Control Policy of the Government of India for the provisions of section 115 to be applicable.

Section 42 provides that for the purpose of computation of the profits or gains of any business comprising prospecting for or extraction or production of mineral oils in relation to which the Central Government has entered into an agreement with any person for association or participation of the Central Government (or any person authorised by it) in such business, there shall be made in lieu of or in addition to the allowances admissible under this Act, further allowances as specified in the agreement in relation to expenditure by way of infructuous or abortive exploration, or depletions of mineral oil in the mining area, starting from the first year of commercial production.

Section 293A further provides that if the Central Government is satisfied on grounds of public interest, it may by notification make an exemption, reduction in rate or other modification in respect of income tax in favour of persons, with whom the Central Government has entered into agreements, as mentioned in Section 42.

The Act has also introduced certain provisions for computation of the income of a non-resident from some specific businesses on the basis of a presumptive rate of taxation. Section 44B provides that in the case of a non-resident engaged in the business of operation of ships a sum equal to 7.5 percent of the aggregate of amounts payable on accounts of the carriage of goods etc, shipped at any port in India and the amount received in India on account of carriage of goods etc shipped at any port outside India, shall be deemed to be the profits and gains of such business chargeable to tax under the head 'profits and gains of business or profession'. Section 44BBA incorporates a similar provision for a non-resident engaged in the business of operation of aircraft with the presumptive rate for estimating income being 5 percent of such amounts. Section 44BB provides that in the case of a non-resident, engaged in the business of providing services or facilities in connection with, or supplying plant and machinery on hire used or to be used in the prospecting for, or extraction or production of mineral oils the taxable income would be 10 percent of the aggregate of amount payable to the non-resident on account of the provision of service and facilities referred to above in India and the amount received in India by the assessee on account of the provision of services and facilities referred to above outside India. This provision does not apply in a case where the provisions of sections 42/ 44D/ 115A/ 293A apply. Lastly, section 44BBB provides that in the case of a foreign company engaged in the business of civil construction or the business of erection of plant or testing or commissioning thereof in connection with a turnkey power project approved by the Central Government and financed under any international aid programme, the taxable profit will be a sum equal to 10 percent of the amount payable to the said assessee on account of such activities.

The AAR has ruled in number of cases in the respect of application of the above mentioned provisions. In the case of **Ericsson Telephone Corporation AB Vs CIT (224 ITR 203),** a company incorporated in Sweden entered into contracts with three Indian companies for the introduction of the cellular system of telecommunication in India. It undertook for an agreed consideration, installation of GSM mobile telephone system and related services in India. The hardware belonged to and software was licensed to the Indian companies. For this purpose, it opened branch offices in India at New Delhi, Bombay and Madras. The AAR held that the remuneration received by the company would qualify as ‘fees for technical services’ as defined in Article 13 of the DTA between Indian and Sweden. Since the fee arose in the course of business through a PE in India, it would be governed by Article 7 of the Agreement, which dealt with business profits. Article 7(3) requires that in determining the profits of a PE only such expenses can be allowed, as are allowable under the provisions of domestic law of the contracting state in which the PE is situated. In this connection, section 44D(b) of the Act prescribes that no deduction for expenses should be allowed in computation of income by way of ‘fees for technical services’ received in pursuance of an agreement made by the foreign company with Indian concerns after March 31, 1976. As a result, the entire gross amount of fees received by the foreign company would be liable to tax at the rate of 55 percent. On the other hand, if the above agreements between the foreign company and Indian concerns were approved by Central Government or the agreements were in accordance with the Industrial Policy of the Central Government, the consideration shall be taxed under the provisions of section 115A(1)(b) at the rate 30 percent on a gross basis.

Again in **P No 6 of 1995 (234 ITR 371)**, the AAR explained that Section 44D is a substantive section and is a special provision for computing income by way of ‘royalties’ and ‘fees for technical services’ in the case of foreign companies. Clause (b) of section 115A provides the machinery for taxation of such ‘royalties’ and ‘fees for technical services’. These are special provisions which have to be read together for computing and taxing income by way of ‘royalties’ and ‘fees for technical services’ in case of foreign companies. Section 44D is applicable in respect of ‘royalties’ and ‘fees for technical fees' arising in the course of a business and it overrides sections 28 to 44C, including section 44BB. Section 44BB operates in a sphere that is totally different from that of section 44D. Section 44BB applies to income arising from services and facilities in connection with or supplying plant or machinery on hire used or to be used in the prospecting for or extraction or production of mineral oils in India, which would not be in the nature of 'royalty' or 'fees for technical services' within the meaning of sections 9(1)(vi) and 9(i)(vii) of the Act. The AAR also pointed out that the entire scheme of the Act ie sections 9(1)(vi) and (vii), 44D and 115A clearly show that the underlying idea is to provide special tax treatment to income arising under the head 'royalties' and 'fees for technical services' to foreign companies in two ways ie prescribing a rate which is lower than the general rate of tax on the other income and secondly taxing gross amount of receipts. However, where DTA provides for taxation of royalties and fees for technical services at a rate which is more beneficial to the taxpayer, the provisions of Sections 44D and 115A of the Act, would not be applicable.

Further, it was held by the AAR in the case of **Niko Resources Ltd Vs CIT (234 ITR 828)** that if a non-resident is engaged in the business of prospecting for or extraction or production of mineral oil, the income arising therein shall be considered to be 'business income', and if the certain conditions are satisfied, the provisions of section 42 would apply. While computing total income, in the event that any relief has been given to an assessee under any other section of the Act, the same would also be allowed. However, if the total income of the assessee computed as above is less than 30 percent of his book profit as defined in section 115JA, 30 percent of book profits will be deemed to be the assessees total income. Neither section 42 nor any notification issued under section 293A can prevent the application of section 115JA.

6.4 **Provisions relating to 'royalty' and 'fees for technical services' under the Act**

The Finance Act, 1976 introduced clauses (vi) and (vii) of section 9(1) of Act with effect from April 1, 1976. Clause (vi) provides that income by way of 'royalty' payable by the Government, a person who is a resident or a person who is a non-resident, (where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning income from any source in India) shall be deemed to accrue or arise in India. Income by way of 'royalty' in form of lump sum payment made by a person who is a resident for the transfer of all or any rights (including the grant of license) in respect of computer software (as defined in explanation to section 80HHE) supplied by a non-resident manufacturer along with a computer or computer based equipment is, however, excluded.

‘Royalty’ has been defined in explanation 2 to section 9(1)(vi) as 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) 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) Imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or the process or trade mark or similar property;

(iii) Use of patent, invention, model, design, secret formula or process or trade-mark or similar property;

(iv) Imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(v) Transfer of all or any rights (including granting of licence) in respect of any copy right, 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 cinematography films; or

(vi) Rendering of any services in connection with the activities referred to in sub clauses (i) to (v).

Clause (vii) of section 9(1) of the Act, provides that income by way of ‘fees for technical services’ payable by the Government, or a resident person (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 a non-resident person (where the fees are payable in respect of services utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India) shall be deemed to accrue or arise in India.

Explanation 2 to the clause defines 'fees for technical services' to mean 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".

Based on the above, income by way of ‘royalties’ and ‘fees for technical services’ payable to a non-resident are deemed to accrue or arise in India, in the event that the technical know-how or information for which royalty is paid or the technical services are utilised in a business carried on in India. It is no longer relevant where the services are rendered and where the payment is made. The AAR has also confirmed the above position in several cases. In the case of **Steffen, Robertson & Kirstel Engineers Vs CIT (230 ITR 206)**, a company incorporated under the laws of South Africa and having its registered office in Johannesburg, signed a technical consultancy agreement with TISCO, India for providing engineering services to the latter. The operations under the agreement were divided into different stages and some of the work was to be carried out at Johannesburg office and some in India. The agreement provided for separate costs and fees for each stage of work. The AAR held that the fees paid by TISCO would clearly fall within the scope of definition of the expression ‘fees for technical services’ as defined in explanation 2 to section 9(1)(vii) of the Act. These amounts were being paid by TISCO, which was a resident of India and the statutory test for determining the place of their accrual was not the place where the services for which the payments were made were rendered, but the place where these services were utilised. If they were paid for services, which were utilised in a business or profession carried on by the payer in India or for the purposes of making any income from a source in India, they would be deemed to accrue or arise in India, irrespective of whether the services were rendered in India or outside.

An interesting issue arose in the case **P No 22 of 1996 (238 ITR 99).** A Swedish company having a wholly owned subsidiary in USA was the proprietor of a trademark in India. The wholly owned subsidiary acquired proprietary interest in the trademark. There was another company incorporated in USA which has a wholly owned subsidiary. The said wholly owned subsidiary held 51 percent of the equity capital of an Indian company. In pursuance of an agreement between the subsidiary of the Swedish company, and the Indian company, the Swedish company had granted the Indian company the right to use the trademark in India in carrying on its business in refrigerators and other articles subject to payment of certain royalties to the former. This situation underwent a change with a "trademark usage and purchase agreement" entered into on August 15, 1994 between the American company, the Swedish company and its subsidiary. Under this agreement, all existing trademark and trade name licences from the Swedish company and/ or its subsidiary in favour of the Indian company were to terminate from a date mentioned in the agreement. The agreement envisaged that notwithstanding the termination of its rights, the Indian company would be entitled to the continued use of the trademark and the trade name during a phase out period of 24 months from the termination date without any further payment, but subject to certain restrictions. The agreement however provided that in consideration of the "trademark agreement", the American company will pay to the subsidiary of the Swedish company US$ 5,295,756. The agreement also provided that the subsidiary of the American company will purchase or cause to be purchased from the subsidiary of the Swedish company all the equity shares held by it in the Indian company at a price of US$ 10,524,477. But neither the Indian company nor the subsidiary of the American company paid any consideration under the agreement. The royalty for the licence to the Indian company was for the right to continue to use trademark and trade name in India during the phase out period. The purchase price of shares was paid by the American company to the subsidiary of the Swedish company. The issue arose whether royalty paid outside India by the American company to the subsidiary of the Swedish company as a consideration for granting the licence and right to the Indian company to use the trademark in India was liable to Indian tax. The AAR held that there are recitals in the agreement which indicate that the American company is anxious to enter the Indian market with like products and wants to take over the mantle of the Indian company as a step-in-aid to introduce its own brands in the Indian market. It is with a view to achieving the above objective, that it had acquired the shares in the Indian company and was planning to introduce its products in the Indian market by making use of the Indian company and its subsidiary also in a limited manner during the phase out period. Thus, it cannot be said that the American company had nothing to gain as a result of the agreement and the royalty amount was paid gratuitously on behalf of the Indian company. The AAR also pointed out that the second part of the clause (c) of section 9(1)(vi) of the Act deems 'royalty' to accrue or arise in India, where it is payable in respect of the right, property or information used for the purposes of making or earning any income from any source in India. In the instant case, there is no reference to the person who is liable to pay the royalty for a business carried on by him in India. It is sufficient that the property (in this case the trademark) in respect of which royalty is payable is used to earn income from any source in India. The licence agreement itself recites that the American company desires to use the trademark in India through the Indian company in respect of refrigerators and other licenced products, the sale of which constitutes a source of income of the Indian company in India. There is therefore no doubt that in terms of clause (c), the royalty in question must be deemed to accrue or arise to the subsidiary of the Swedish company in India and hence taxable.

6.5 Provisions relating to 'royalty' and 'fees for technical (included) services' as outlined in DTAs

The agreements for DTA entered into with different countries by Government of India also provides for taxation of income by way of 'royalty' and 'fees for technical services' paid from India on the basis of "payments from India" principle. Article 12 of the DTA between India and USA provides in paragraph (1) that royalties and fees for included services arising in a contracting state and paid to the resident of other contracting state may be taxed in that other state. However, paragraph 2 provides that such royalties and fees for included services 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 or fees for included services is a resident of the other contracting state, the tax charged shall not exceed 10 percent to 20 percent of the gross amount of royalties and fees for included services (percentage depending on certain parameters). Paragraph 6 of the Article provides that 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 PE 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 PE or fixed base. In such a case the provisions of Article 7 (business profits) or Article 15 (independent personal services) as the case may be shall apply. Paragraph 7 provides that royalties and fees for included services shall be deemed to arise in a contracting state when the payer is the state itself, a political subdivision, 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 PE 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 PE or fixed base, then such royalties or fees for included services shall be deemed to arise in the contracting state in which the PE or fixed base is situated. The paragraph also provides that where under the above rules, 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. Paragraph 8 provides that 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 DTA.

For the purposes of this Article, the term 'royalties' has been defined to mean payments of any kind received as consideration for the use of, or the right to use any copy right of a literary, artistic or scientific work, including cinematographic films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of a such right or property which are contingent on the productivity, use or disposition thereof; and payment of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than payments derived by an enterprise engaged in the operation of ships or aircraft in international traffic from the rental of ships or aircraft incidental to any activity directly connected with such transportation, or from the use, maintenance or rental of containers, used in connection with the operation of ships or aircraft in international traffic. It would be noted that the first part of the definition of royalty in the DTA is coterminous with the definition of ‘royalty’ as provided for in explanation 2 to section 9(1)(vi) and also treats payment for use of any industrial, commercial or scientific equipment as royalty, which has been incorporated in the Act with effect from April 1, 2001.

In the DTA, ‘fees for included services’ has been defined to mean 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 as royalty 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.

It is however clarified that ‘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, referred to in the definition of royalty.

(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.

(e) to an employee of the person making the payment or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (independent personal services).

It would be seen that the definition of ‘fees for technical services’ is much wider in explanation 2 to section 9(1)(vii) of Act, than in the DTA. The DTA only covers services ancillary and subsidiary to enjoyment of the right of use of technical know-how, information, etc, which give rise to royalty payment or services involving transfer of technical knowledge, skill, etc while the definition under the Act covers all technical, managerial or consultancy services, excluding consideration for any project for construction, assembly, etc.

The provisions regarding taxation of royalties and fees for (included) technical services in the DTAs with UK, Canada, Australia and Switzerland are on the same lines as in the agreement with USA. But in the DTAs with France, Germany, China, Japan, Sweden, Spain, South Africa, the definition of ‘fees for technical services’ is wider and almost on the same lines as the explanation 2 to section 9 (1)(vii) of the Act. The above term is defined in these agreements to mean payment of any kind in consideration for the rendering of any managerial, technical or consultancy services including provision of services by technical or other personnel, but does not include payments for independent personal services (professional fees) or dependent personal services (salary) as envisaged under Articles 14 and 15.

The meaning of the term 'royalties' in the DTA between India and USA has been interpreted by the AAR in **P No 30 of 1999 (238 ITR 296)**. In this case, company incorporated in USA belonged to a group of companies engaged in worldwide credit card and travel business. It was engaged in providing international credit cards, traveller’s cheques and other travel related services. These instruments are used, discounted and encashed all over the world by travellers on tour or business. To keep track of the expenses incurred on traveller’s credit card or purchase and encashment of traveller’s cheques, etc, the USA company maintained a centralised computer in USA. The centralised computer or Central Processing Unit (“CPU”) was a huge high technology computer complex having 15 to 20 main frame IBM computers and other related hardware and software facilities involving substantial investment and capable of very high volume storage and high speed processing of data. The above CPU was accessed and used by various group entities located worldwide through a consolidated data network maintained in Hong Kong. The transactions done by a traveller in a particular country were reported to a centralised computer in that particular country. In India, the centralised computer was maintained by an Indian company located at Delhi. This company received information on computer through telephonic or microwave links about the use of credit cards and travellers' cheques by travellers all over the country. It also serviced thirteen group companies in Asia and the Pacific in a similar manner. The information was then passed on to the Hong Kong computer centre of the American company. For carrying out this operation, the Indian company obtained leased lines from VSNL. The American company charged the Indian company for the use of its computers in Hong Kong and USA. The Indian company was a subsidiary of the American company. The issue which was placed before the AAR, was whether the payment due to the American company from the Indian company was liable to tax in India and if so whether it was covered under Article 12(3)(a) or 12(3)(b) of the DTA between India and USA. The AAR ruled that the definition of the expression 'royalty' under section 9(1)(vi) of the Act read with clause (vi) of the explanation includes rendering of any services in connection with any activities for the use of any patent, invention, secret formula or process, etc. In the instant case, the concept of "source" against "residence" becomes more significant as the issue relates to cyberspace activities. The transmission of information is through encryption as the data relates to clients and strict confidentiality is observed. It is for the downloading of the software that the royalty is paid. In this context, the source rule becomes relevant which requires that royalty is sourced in the state of the payer. According to the agreement between the American company and the Indian company, the facilities are to be accessed only by the Indian company. The consideration payable is for the specific programme through which the Indian company is able to cater to the needs of the group companies located in Japan and other places. The transaction would relate to a "scientific work" and would partake the character of intellectual property. The payments received in such transactions are for the use of intellectual property and partake the character of royalty. The software is customised and secret. From the facilities provided by the American company to the Indian company, which are of the nature of online, analytical data processing, it would be clear that the payment is received as "consideration for the use of, or the right to use design or model, plan, secret formula or process". The use by the Indian company of the CPU and the consolidated date network of the American company is not merely "use of or the right to use any industrial, commercial or scientific equipment" as envisaged in Article 12(3)(b) of the DTA but more than that. It is the use of embedded secret software (an encryption product) developed by the American company for the purpose of processing raw data transmitted by the Indian company, which would also clearly fall within the ambit of Article 12(3)(a) of the DTA between India and USA.

Article 12(b) of the DTA between India and USA provides that the main provisions for taxation of royalties and fees for included (technical) services shall not apply if the beneficial owners of the royalties for fees for included services, being a resident of a Contracting State carried on business in the other Contracting State in which the royalties or fees for included services arise, through a PE 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 a case the provisions of Article 7 (business profits) or Article 15 (independent personal services) as the case may be shall apply.

The AAR discussed the above principles in **P No 13 of 1995 (228 ITR 487)**, while dealing with the DTA between India and Germany and noted the different words used in the said treaty, according to which the provisions of Article 7 or Article 15 as the case may be shall apply, if the right, property or contract in respect of which the royalties or fees for technical services are paid, is effectively connected with such permanent establishment or fixed base, and under Article 7(1) or 15(1), business profits from 'royalty' or 'fees for technical services' would be taxable only to the extent such profits are directly and indirectly attributable to that PE or fixed base. In that case a foreign company having a PE in India provided technical know-how etc. to an Indian company from abroad. The technical documents containing the knowhow were transferred outside India. The AAR held that though the intellectual property, in respect of which royalty was paid, was effectively connected with the PE in India, the royalty was not directly or indirectly attributable to the PE and hence not taxable in India.

In cases of manufacturers of computer software programmes earning income from customers world over by allowing the right of use of the software programme, patented by them, a question that merits attention is whether the income earned is in the nature of royalty (consideration for right of use of the programme) or profit from sale of intangible products manufactured by them. In these transactions, generally the customer is granted perpetual license for own use of the software program. Sale to a third person or even use by a third person is prohibited. While the OECD countries do not consider such income as ‘royalty’, unless the user is granted right to commercially exploit the programme by making copies and allowing others to use it, in India some of the tax authorities are taking the view that the payment received by the software manufacturer from the customer is in respect of right of use of the software only and constitutes royalty. This view has no effect in the cases of Indian software manufacturers as their global income is taxed subject to the allowance of deductions available under sections 80HHE and 80 HHD of the Act in respect of profits derived from export of computer software, film software, television software, music software, television news software etc., or from rendering technical services outside India in connection with the development and production of computer software. However, the Indian software manufacturer is likely to suffer taxation in a foreign country, in cases of export of computer software, if the taxing authorities in the country take a similar view. However, treating payments made by Indian software companies for import of patented computer software from abroad as ‘royalty’ would result in withholding of tax from such payments.