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Consideration for providing access to internet, email and networking facilities which provide a gateway to call centers for incoming and outgoing calls is taxable as royalty under the Income-tax Act and under the India-USA tax treaty

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Cincom System Inc.[1] (the taxpayer) held that consideration received by a foreign company for providing access to its internet, email and networking facilities by which it provides a gateway that will facilitate call centers for incoming and outgoing calls from India to the USA and vice-versa is taxable as royalty under the Income-tax Act, 1961 (the Act) and under the India-USA tax treaty (the tax treaty).

Facts of the case

- The taxpayer, a foreign company, is engaged in the business of providing software solution including creating personalised document, management of solutions, etc.
- The taxpayer company entered into the 'Communication Agreement' with Cincom Systems (India) Pvt. Ltd. wherein it was agreed that the taxpayer shall provide access to Cincom Systems (India) Pvt. Ltd. to the internet and other email and networking facilities along with other group concern. In consideration of providing these services, the taxpayer company was paid a certain sum.
- For the Assessment Year (AY) 2002-03, the taxpayer company offered such amount as Fees for Included Services (FIS). However, before the Commissioner of Income-tax (Appeals) [CIT(A)], the taxpayer contended that the amount was not taxable in India. The CIT(A) held that the payment was not in the nature of FIS, however, held that it was in the nature of royalty, placing reliance on the decision of Authority for Advance Rulings (AAR) in the case of Abc[2].

Tribunal's ruling

- Perusal of the 'Communication Agreement' indicates that the taxpayer provided access to its internet facility by which it provides a gateway that will facilitate call centers to incoming and outgoing calls from India to the people of USA, referred as Cincom Gateway.
- The consideration for such services falls within the definition of 'royalty' as defined under the provisions of 9(1)(vi) of the Act. However, since the taxpayer is a resident of USA, it was entitled to be governed by the provisions of the tax treaty.
- This was a case of use of embedded secret software owned by the taxpayer company for the purpose of enabling the customer from India to call the residents of USA or vice-versa.
- In the case of Abc, almost identical facts were involved wherein the company incorporated in the USA. was engaged in providing international credit cards, traveller's cheques and other travel related services. These instruments were used, discounted and encashed all over the world by travelers on tour or business.

[1] Cincom System Inc. v. DDIT [ITA No. 952/Del/2006, AY: 2002-03] (Del) – Taxsutra.com

[2] Abc [1999] 238 ITR 296 (AAR)

- 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 or Central Processing Unit (CPU) in USA. The 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 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 traveler 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 travelers 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.
- 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 AAR held 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 was through encryption as the data relates to clients and strict confidentiality was observed. It was 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 were to be accessed only by the Indian company.
- The consideration payable was for the specific programme through which the Indian company was able to cater to the needs of the group companies located in Japan and other places. The transaction would be related to a 'scientific work' and would partake of the character of intellectual property and therefore, in the character of royalty.
- The software was customised and a secret. From the facilities provided by the American company to the Indian company, which were of the nature of online, analytical data procession, it would be clear that the payment was 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 data network of the taxpayer was not merely 'use of or the right to use any industrial, commercial or scientific equipment' as envisaged in Article 12(3)(b) of the tax treaty but more than that.
- It was the use of embedded secret software (an encryption product) developed by the American for the purpose of processing raw data transmitted by the Indian company, which would fall within the ambit of Article 12(3)(a) of the tax treaty.
- The reliance placed by the learned counsel on the decision of the Delhi High Court in the case of Asia Satellite Telecommunication Co. Ltd.[3] is totally misplaced. In that case, use of a transponder was involved which was not a self-contained operating unit. It is in the orbit with footprints all over the world so that its location cannot be attributed with reference to location of its customers.
- Accordingly, the ratio of the ruling of Authority for Advanced Ruling in the case of Abc, was applicable in the present case, and the consideration paid was in the nature of royalty within the meaning of Article 12(3) of the tax treaty.

Our comments

The Delhi Tribunal, in the present case, relying on the decision in the case of Abc, held that consideration received by a foreign company for providing access to its internet, email and networking facilities by which it provides a gateway that will facilitate call centres for incoming and outgoing calls from India to the USA and vice-versa is taxable as royalty under the Act and under the tax treaty.

The Mumbai Tribunal in the case of Euro RSCG Worldwide Inc[4] held that co-ordination fees paid to the USA company for maintaining a communication channel between an Indian company and its clients is not in the nature of royalty because it was not a consideration for the use of right or to use any of the specified terms mentioned in the definition of royalty under Article 12 of the tax treaty.

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[3] Asia Satellite Telecommunication Co. Ltd. v. DIT [2011] 332 ITR 340 (Del)
[4] DDIT v. Euro RSCG Worldwide Inc (ITA No. 7094/Mum/2010)

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