

CTR ENCYCLOPAEDIA ON INDIAN TAX LAWS

ABC, IN RE

AUTHORITY FOR ADVANCE RULINGS

Suhas C. Sen, J., Chairman; Dr. Subhash C. Jain & Dr. Mohini Bhussry, Members

P. No. 30 of 1999

28th April, 1999

(1999) 154 CTR (AAR) 246 : (1999) 238 ITR 296 (AAR) : (1999) 105 TAXMAN 240 (AAR)

Legislation referred to

Section 9(1)(vi), 90,

Case pertains to

Asst. Year -

Decision in favour of

Revenue

Double taxation relief—Agreement between India and U.S.A.—Charges receivable by American company for use of computer software—American company Y having a global central processing unit (CPU) in USA allowed access to and use of its CPU/CDN to Indian company XT as one of its customers—XT is retrieving processed **data from the CPU and is making payment to Y only for having access to this **data**—Thus, XT is allowed to use the software developed and protected by Y—Payments received in such transactions are for use of intellectual property and partake the character of royalty—**Data** is collected in India—Therefore, income is arising in India and is taxable as 'royalty' under art. 12(3) (a) of DTAA**

Held

The CPU of 'Y' (applicant) has its own software and is operated by its own personnel in USA. 'XT' is retrieving from the CPU the processed **data** of its customers and the 'XT' is to make payment to 'Y' only for having access to this **data** and to use the computer system. This clearly establishes that the software used in the computer system. This clearly establishes that the software used in the CPU is that of the applicant and it has allowed the Indian company to use its software. The same software is also used by various other subsidiaries and group companies of the applicant. The actual use of CPU at USA is not directly accessible to the Indian company. The Indian company accesses the CDN computer system of the applicant at Hong Kong. After having accessed the CDN, it establishes access to the CPU through the CDN. At both the stages, the Indian company is allowed to use the software developed and protected by the applicant company. As is the practice in Canada, USA and other developed countries, allowing the use of protected software for a consideration by way of a contract amounts to income by way of royalties covered under art. 12(3) (a) of the DTAA. It would appear that there are three main ingredients which partake of the character of royalty payment : (1) it is a payment made in return for a right to exercise a beneficial privilege or right, (2) the payment is made to the person who owns the right, and (3) the

consideration payable is determined on the basis of the amount of use. All these tests squarely cover the CPU and CDN charges payable by the Indian company.

(Paras 28, 29 & 31)

The definition of the expression 'royalty' under s. 9(1)(vi) of the IT Act, 1961, and Explan. 2(vi) includes rendering of any services in connection with any activities for the use of patent invention, secret formula or process, etc. Hence, the concept of "source" as 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, source rule becomes relevant which requires that the royalty is sourced in the State of the payer. As per the Agreement, the facilities are to be accessed only by 'XT'. The consideration payable is for the specific programme through which 'XT' is able to cater to the needs of ABC companies located in Japan, Asian Pacific, Australia and New Zealand. Reference to Klaus Vogel's Commentary would support the view that the transaction would relate to a 'scientific work' and would partake of the character of intellectual property. The applicant is using client service technology. The **data** is collected in India and, admittedly, due to appreciable volume of work the American concern is providing services under consideration. The income is arising in India and is taxable as 'royalty' under art. 12(3)(a). The software being used is specifically developed by the applicant company under an agreement signed in 1994 and renewed in 1997. The software is customised and secret. This clearly flows from para 3 of the letter of the applicant dt. 22nd July, 1998 that the CPU has its own software belonging to the applicant. From the facilities provided by the applicant to the Indian company, which are in the nature of online, analytical **data** processing, it would be quite clear that the payment has been received as "consideration for use of, or the right to use.....design or model, plan, secret formula or process....." within the meaning of the term 'royalties' in art. 12(3)(a). The use by 'XT' of CPU and CDN of the applicant is not merely use of equipment as envisaged in art. 12(3)(b) of the DTAA but is more than that. From the transactions of the applicant with the Indian company it is quite clear that CPU/CDN of the applicant are modern technological designs or models involving customised communication and computation with application of sophisticated information technology requiring constant upkeep and updating so as to meet the challenge of the advance of technology in this area. It is the use of embedded secret software (an encryption product) developed by the applicant for the purpose of processing raw **data** transmitted by 'XT' which clearly falls within the ambit of art. 12(3)(a) of the DTAA. In the instant case, the precise amount of royalty to be paid by 'XT' is calculated on the basis of time taken by the CPU in processing the **data**. It is well-known that the rate of royalty can be either fixed or subject to variations depending on certain parameters, as, for example, the time taken in processing the **data** as in this case. Accordingly, the payment received by the applicant is liable to tax in India as 'royalty' in terms of art. 12(3)(a) of the DTAA.

(Paras 35 to 39)

Conclusion

Charges received by American company from an Indian company for allowing access to and use of its central processing unit (CPU) at USA and **consolidated data network** (CDN) thereby allowing the latter to use the software developed and protected by the former is income arising in India and is taxable as 'royalty' under art. 12(3)(a) of DTAA between India and USA.

Decision in favour of

Revenue

Ruling

DR. MOHINI BHUSSRY :

The present application has been filed by M/s 'Y' under s. 245Q(1) of the IT Act, 1961.

2. The applicant, 'Y', is a company formed and incorporated in USA and belongs to the 'ABC' group of companies which operate in the worldwide credit card and travel business. 'Y' is a wholly owned subsidiary of 'X'. 'Z' is a wholly owned subsidiary of the applicant company. In other words, 'Y' is the holding company and 'Z' is its wholly owned subsidiary company.

3. An Indian company by the name of 'XT' was incorporated as a private limited company on 28th June, 1994, having its main object as the operation of a high technology centre for **data** management, information analysis and control of ABC group and other companies in Asia, Europe or elsewhere. It became a deemed public company w.e.f. 1st April, 1997, by virtue of provisions of sub-s. (1A) of s. 43A of the Companies Act, 1956, on the basis of turnover criteria. It has set up a 100% EOU and has commenced commercial operations and export from June, 1995, to various countries around the world. The activities/operations of its business in its EOU involve **data** management, information analysis and control. Its customers currently consist of various 'ABC' companies located in different countries. It needs to be mentioned here that 'XT' is a wholly owned subsidiary of 'Z' of USA.

4. 'Y', the applicant company has, inter alia, a Worldwide Information Processing Telecommunication Centre (hereinafter referred to as "WPIT Centre") at USA. It owns and maintains at the said WPIT Centre a huge high-tech computer complex having 15 to 20 mainframe IBM computers and other related hardware and software facilities involving substantial investment and capable of very high volume storage and high speed processings of **data**. 'Y' allows its customers to have access to and to use its Central Processing Unit (CPU) at USA against payment. 'XT' is one such entity which uses Y's extensive CPU setup in USA to meet part of its processing needs. The CPU of 'Y' at USA is accessed and used by various 'ABC' entities located worldwide through a **Consolidated Data Network** (CDN) maintained at Hong Kong. 'XT' has its microwave/world link up to CDN at Hong Kong through VSNL.

5. For use of the main frame (CPU) situated at USA and **Consolidated Data Network** (CDN), 'XT' entered into an agreement with 'Y' in June, 1994. The said agreement enjoins that 'XT' shall pay the amount of invoices raised by 'Y' after making necessary withholding tax.

6. 'Y' allows use of its mainframe situated at USA and also incidental electronic mail access, **consolidated data network** access and **consolidated data network** services to 'XT' and bills 'XT' on the following basis :

CPU charges	Actual utilisation of mainframe time by 'XT' staff.
Electronic Mail charges, Mail ID being used.	\$32 per month per Electronic Mail ID being used.
CDN access charges	Actual bandwidth connected+ network management fees.
CDN Service charges	Actual number of communication controllers, terminals, parts.

7. 'Y' is engaged in providing international credit cards, travellers' cheques and other travel related services. These instruments are used, discounted and encashed all over the world by travellers on tour or business. The keep track of the expenses incurred on a travellers credit card or purchase

and encashment to travellers' cheques, etc., 'Y' maintains a centralised computer in USA. For their basic operations, they have a computer set up in Hong Kong. The two systems are linked by satellite communication.

8. The transactions done by a traveller in a particular country are reported to a centralised computer in that country. In India, this is done by 'XT', located at Delhi. The said Indian company receives information on computer through telephonic and microwave links about the use of credit cards and travellers' cheques by travellers all over the country. 'XT' is also servicing thirteen group companies in Asia and Pacific, in a similar manner. The information is then passed on to the Hong Kong computer centre of the applicant. For carrying out this operation, 'XT' has obtained leased lines from VSNL. The applicant company, 'Y' charges XT, the Indian company, for the use of its computer set up in Hong Kong and that in USA at the rates specified in para 6 above.

9. The questions posed in the application are as under :

(i) Whether payment due to the applicant under the transaction mentioned in Annexure B is liable to tax in India ?

(ii) If the answer to the question No. 1 is in the affirmative, whether the payment due to the applicant under the transaction mentioned in Annexure B is covered under art. 12(3)(a) or art. 12(3)(b) of the Double Taxation Avoidance Agreement between India and USA ?

10. To put the question raised by the applicant in proper perspective, it would be in order to reproduce part of the said Annexure-B referred to above :

ANNEXURE - B

Relevant facts

The application pertains to the liability to tax in India of the charges receivable by the applicant from an Indian company for the use of the applicant's 'Central Processing Unit' (CPU) at USA and '**Consolidated Data** Net work' (CDN).

A. The Applicant

The management and control of the applicant is not situated in India.

B. The Indian company (XT)

The Indian company has a 100% EOU for performing activities of '**data** management, information analysis and control' for XT's customers. 'XT' has its own infrastructure in terms of processors/related computer equipment, own microwave tower, leased circuits and so on.

C. 'Central Processing Unit' (CPU) in USA

The applicant inter alia has a global 'Central Processing Unit' (CPU) in USA where the applicant has installed several IBM mainframes/other equipment for operating various ABC Group systems/applications and for storing **data**. These facilities are being accessed by various subsidiaries/affiliates of ABC Group, USA located in different parts of the world.

D. '**Consolidated Data Network**' (CDN)

The 'central processing unit' (CPU) in USA of the applicant is accessed and used by various ABC

entities located worldwide through a '**consolidated data network**' (CDN) maintained outside India by the applicant.

The '**consolidated data** net work' (CDN) of the applicant inter alia comprises equipment and leased circuits, etc. of the applicant either owned by it or taken on lease.

The applicant maintains its CPU and CDN, and ensure uptime of the said CPU/CDN for the various users at the applicant's own cost and expense. The applicant raises invoices monthly for charges.

E. CDN/CPU use

The applicant has inter alia allowed access to and use of its CPU/CDN to the Indian company viz. 'XT', as one of its customers for such use.

The applicant allows 'XT', to access and use the applicant's CDN/CPU, which 'XT', uses to process information/**data** inter alia for customers of 'ST' and for delivering the processed information/output through XT's communication connectivity through electronic-mail worldwide and related storage requirements.

The applicant's 'central processing unit' (CPU), is accessed by XT, as follows :

*'XT' links up with the applicant's CDN, at Hong Kong through dedicated international leased circuit lines of Videsh Sanchar Nigam Ltd. (VSNL).

*'XT' then accesses the applicant's CPU at USA using the applicant's CDN from Hong Kong.

11. It has been stated by the authorised representative of 'Y' that the use of CDN/CPU of the applicant company is located outside India and 'XT' pays charges by way of remittance in foreign exchange which are received by the applicant company outside India. Accordingly, 'XT' is operating as a separate business entity in India having set up and invested substantially in its EOU, undertaking significant exports and earning substantial foreign exchange for India, employing well trained and expert local employees in large numbers and having its one full-fledged business set up in India being run with its own highly sophisticated and advanced technological infrastructure and equipment installed in India.

12. It is claimed that 'XT' is an Indian company and it is not connected with the applicant. The applicant company receives charges for use of CPU and CDN by 'XT'. Since the processing of the **data** is done in the computers located in Hong Kong and USA and not in India, no business activity of the applicant arises in India and hence the charges paid by 'XT' to the applicant are not taxable in India.

13. 'XT' is registered as an Indian company as a 100% export oriented unit. It provides customers services, mainly, by way of **data** processing to 13 companies of the ABC group located all over the world, mainly, in Asia and the Pacific. The income of 'XT' is, therefore, received in foreign exchange for export of software and hence it is exempted from income-tax under s. 80HHE. For doing **data** processing work pertaining to the travel related services, 'XT' accesses the centralised computer of the applicant company located both in Hong Kong and in USA. As already set out above, 'XT' has been authorised by an agreement with the applicant company to use the applicant's computer system. 'XT' also uses the software developed by the applicant company available in the computer system to process the **data**. 'XT' feed in **data** into this computer system and also retrieves processed **data** from it. As mentioned above, the access to the applicant's computer system both in Hong Kong and in USA is made available to 'XT' through VSNL satellite link and information from all over the world is sent to India, processed and sent back.

14. It was argued that the applicant and 'XT' operated at an arm's length. In other words, 'XT' is an individual profit centre. The services rendered by 'XT' relate to the customers of the applicant group of companies. P&L a/c of 'XT' furnished at the time of hearing for the year ending 31st March, 1997, shows their income from **data** management and information analysis. Major expenses include CPU and CDN charges payable to the applicant company appearing in Schedule (G), para B(2) of the Notes forming part of the accounts of the company which state as under :

BALANCE SHEET AS AT 31ST MARCH, 1997

SCHEDULE (G)

B. Notes forming part of the accounts.

1. Estimated amount of contracts remaining to be executed on capital account and not provided for (net of advances)—Rs. 22,915,065.00 (previous year—Rs. 7,845,577.00).

2. The company has made a provision of Rs. 63,923,820.02 (US \$ 17,72,561.48) towards charges payable to 'Y', USA for the use of computer **data network** and central processing unit. Out of the above amount, a sum of Rs. 2,69,72,980.24 (US \$ 7,48,002.78) relates to the period June, 1995 to March, 1996.

It appears that no amount has so far been remitted.

15. The first question regarding which the applicant company has sought an advance ruling is, whether the payments due to it from 'XT' for access to and use of its CPU at USA are in the nature of income liable to tax in its hands in India. If the answer to this question is in the affirmative, an advance ruling has been sought as to whether such payment due to it from 'XT' would be in the nature of 'Royalty' within the meaning of that term as in para (3) of art. 12 of the Agreement between the Governments of India and of the USA for avoidance of double taxation of income (for short, "DTAA"), and if so, whether they would fall within the ambit of cl. (a) or cl. (b) of the said para 3 of art. 12 of the DTAA.

16. Regarding the first question, it was submitted on behalf of the applicant company that its liability to tax in India on the payments due to it from 'XT' as business income (other than income by way of royalty" has to be viewed in the light of the provisions of art. 7 of the DTAA (relating to taxation of business income, other than income in the nature of royalty referred to in art. 12), r/w art. 5 of the DTAA which contains an exhaustive definition of the term 'permanent establishment' of the enterprise of one of the Contracting States in the other Contracting State. It was submitted that under the provisions of para (1) of art. 7 of the DTAA, the business profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein and that, in the latter case, only so much of business profit of the enterprise of a Contracting State may be taxed in the other Contracting State as is attributable to the permanent establishment of that enterprise situated in the other Contracting State.

17. It was submitted that the applicant company did not have any 'permanent establishment' in India within the meaning of that term in art. 5 of the DTAA. In this connection, our attention was invited to para (4) of art. 5. It was also stated that as 'XT' was not acting in India on behalf of 'Y' and had neither the authority to conclude any contract on behalf of 'Y', nor was it securing any order in India for 'Y', 'XT' could not be regarded a 'permanent establishment' of 'Y' in India. Furthermore, the fact that 'XT' is a wholly-owned subsidiary of 'Z' of USA and that the latter company, in its turn, was a wholly owned subsidiary of the applicant company would not, by itself, make 'XT' a 'permanent establishment' of 'Y' in India by virtue of the provisions of para (6) of art. 5 of the DTAA. It was submitted that in as much as 'Y' did not have any 'permanent establishment'

in India and all the activities of its CPU in USA were conducted outside India, the payments due to 'Y' from 'XT' for having access to and using the CPU of 'Y' were not liable to tax in its hands in India as business profits (other than income in the nature of royalty and fees for included services referred to in art. 12 of the DTAA).

18. The next question is whether the payments due to 'Y' from 'XT' for the use of the CPU of 'Y' in USA are taxable in India as 'royalty' or fees for included services as defined, respectively, in sub-paras (a) and (b) of para (3) of art. 12 of the DTAA. With regard to the definition of the term 'royalty' in sub-paras (a) and (b) of para (3) of art. 12, it was submitted that the payments in question did not at all fall within the ambit of cl. (b) of that para as they were made in consideration for the use by 'XT' of the industrial, commercial or scientific equipment of 'Y' in its CPU at USA. It was, however, submitted that because by virtue of the provisions in para (2) of art. 12, such payments made be taxed in India only "accordingly to the laws" of India, and as the payments in question were not in the nature of income by way of 'royalty' as per the definition of that term in Expln. 2 to s. 9(1)(vi) of the IT Act, 1961, they were not taxable in the hands of 'Y' in India as its income by way of 'royalty'.

19. With regard to the definition of the term 'included services' in para 4(b) of art. 12 of the DTAA i.e., making available "technical knowledge, experience, skill, know-how, or processes", or "development and transfer of a technical plan or technical design", it was submitted that the payments due to 'Y' from 'XT' for the use of the CPU of 'Y' in USA did not involve the rendering of any such services by 'Y' to 'XT'. In this connection, reference was invited to the clarifications regarding the applicability of the provisions of para (4)(b) of art. 12 of the DTAA contained in the memorandum of understanding concerning royalties and fees for included services, appended to the DTAA. It was also submitted that the payments in question were not taxable in the hands of 'Y' in India as income by way of 'fees for technical services' as defined in Expln.-2 to s. 9(1)(vii) of the IT Act, 1961, as 'Y' was not rendering to 'XT' any "managerial, technical or consultancy services (including the provision of technical or other personnel)" in allowing 'XT' to use its CPU at USA.

20. Finally, it was argued that the payments due to 'Y' from 'XT' for having access to and for using its CPU at USA were not taxable in the hands of 'Y' in India as income accruing or arising or deemed to have accrued or arisen to 'Y' or received by it or on its behalf in India. 'Y' does not have any 'business connection' as such in India as 'XT' is not acting on its behalf and has neither the authority to conclude any contract on behalf of 'Y', nor is it securing any order for it. 'XT' is acting independently for the purpose of its business in India and its dealings with 'Y' are commercial dealings at arm's length.

21. The Departmental Representative on the other hand, argued that there was a strong business connection between the US based 'Y' and Delhi based 'XT'. According to her, the main object of 'XT', inter alia, was the operation of a high technology centre for **data** management, information analysis and control of ABC group (list of 13 companies which are clients of 'XT' was enclosed for ready reference). The interlacing of ABC group companies and the whole gamut of operations carried out, where strict control and secrecy is the main-stay, proves the business connection between the two. Further, the applicants' CPU and CPN are sophisticated facilities using the most modern information technology and it is maintained and constantly updated to keep pace with the progress of technology and needs of the customers worldwide. the Indian company's access to mainframe computer through electronic connectivity on the basis of a contract for use, certainly establishes a business connection of the applicant with the Indian company in India inasmuch as for continuous user of the said facilities, the Indian company makes payments to the applicant. It is not a casual or stray connection between the Indian company and the US company but a continuous one on the basis of contract.

22. The Departmental Representative further stated that since business connection existed, the income should be taxed under the head 'Royalty'. Royalty payment is taxable under s. 9(1)(vi) of the IT Act, 1961, which states that income shall be deemed to accrue or arise in India if the

payments are made in consideration of provisions of facilities and services of the nature defined therein. However, art. 12 of the DTAA between India and USA defines "royalties" and "fees for included services" and since the provisions of DTAA supersede those of the IT Act, the definition of 'royalties' and 'fees for technical services' therein are to be taken into consideration to see whether the payments due to the applicant are taxable under the said article.

23. From the nature of the facilities provided by the applicant to the Indian company, it would be quite clear that the payment has been received as "consideration for use of, or right to use..... design or model, plan, secret formula or process or for information concerning industrial, commercial or scientific experience within the meaning of the term 'royalty' as per art. 12(3)(a).

24. Art. 3(2) of the DTAA with USA deals with general definitions. Art. 3(2) states that any term not defined in the convention, shall have the meaning which it has under the law of that State. However, the term 'royalty' has been explicitly defined in art. 12. That definition would override the definition of 'royalty' as appearing in the IT Act, 1961. The Departmental Representative further argued that the definition of 'royalty' alludes to the concept of 'know-how'. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific, experience, the concept of 'know-how' comes to play a significant role. Know-how is any undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process. The Departmental Representative further reiterated that the payment received as consideration for computer software could be classified as 'royalties'. Software may be described as a programme, or series of programmes containing instructions for a computer required either for the operational process of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media. Klaus Vogel's Commentary on Double Taxation Conventions—3rd Edn.—on art. 12(2) of OECD and U.N. Model was referred to and relied upon. In sum, three main points urged by the Departmental Representative are the following :

(i) The definition of the term 'royalties' in cl. (a) of para (3) of art. 12 of the DTAA covers payments of any kind received as consideration for the use of or right to use any secret formula, or for information concerning industrial, commercial or scientific experience. As the **data** inputs stored in the CPU of 'Y' are confidential/secret and they relate to the business transactions of the concerned parties, the retrieval of such **data**/information by 'XT' from the CPU makes available to it confidential or secret information concerning commercial matters whereby the payments made by 'XT' for obtaining such **data**/ information are in the nature of royalty income.

(ii) Alternatively, the payments in question will be in the nature of royalty income of 'Y' under cl. (b) of para (3) of art. 12 of the DTAA being consideration received by it from 'XT' for the use of industrial, commercial or scientific equipment of 'Y' in its CPU in USA.

(iii) Under the provisions of s. 9(1)(vi) of the IT Act, 1961 income is deemed to accrue or arise in India and is taxable in the hands of the non-resident person even if he is not maintaining any 'permanent establishment' in India where any related activities are carried on.

25. During the course of hearing, a copy of the memorandum and articles of association of the 'XT' was asked for and furnished. As per the memorandum of association of 'XT', one of the main objects of the company is as under :

(i) "To design, develop, maintain, market, buy, import, export, sell, provide, licence, and implement, computer software, hardware, computer systems, programme products and services, to undertake **data** operations processing systems and to act as information technology consultants and to operate a high technology **data** processing centre, for providing management, processing, analysis, development and accounting, information and **data** to ABC companies and other companies in Asia and Europe and other countries."

26. It would be relevant to reproduced paras (2) and (3) of art. 12 of the DTAA which read as under :

"(2) However, 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 so charged shall not exceed :

(a) in the case of royalties referred to in sub-para (a) of para (3) and fees for included services as defined in this article (other than services described in sub-para (b) of this para) :

(i) during the first five taxable years for which this Convention has effect,

(A) 15 per cent of the gross amount of the royalties or fees for included services as defined in this article, where the payer of the royalties or fees is the Government State, a political sub-division or a public sector company; and

(B) 20 per cent of the gross amount of the royalties or fees for included services in all other cases; and (ii) during the subsequent years, 15 per cent of the gross amount of royalties or fees for included services; and (b) in the case of royalties referred to in sub-para (b) of para (3) and fees for included services as defined in this article that are ancillary and subsidiary to the enjoyment of the property for which payment is received under para (3)(b) of this art. 10 per cent of the gross amount of the royalties or fees for included services.

(3) The term "royalties" as used in this article means :

(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means or 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 or any such right or property which are contingent on the productivity, use, or disposition thereof; and

(b) payments 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 described in para (1) of art. 8 (Shipping and Air Transport) from activities described in para (2)(c) or (3) of art. 8."

27. We are not helped very much in analysing the character of the transaction from the information placed before us. As mentioned above, arguments adduced by the Departmental Representative find confirmation in the revised commentary on art. 12 concerning software payments. Notwithstanding the various arguments advanced denying any relationship between 'XT' and 'Y' and non-applicability of the term 'royalty' to the payments made by or amounts payable by 'XT' to the applicant, it will be difficult to agree with their contentions.

28. In para 3 of their letter dt. 22nd July, 1998, the applicant states that the use of its CPU in USA by 'XT' does not at all involve the transfer of any software to the 'XT'. The CPU of 'Y' (applicant) has its own software and is operated by its own personnel in USA. 'XT' is retrieving from the CPU the processed **data** of its customers and the 'XT' is to make payment to 'Y' only for having access to this **data** and to use the computer system. This clearly establishes that the software used in the CPU is that of the applicant and it has allowed the Indian company to use its software. The same software is also used by various other subsidiaries and group companies of the applicant. The actual use of CPU at USA is not directly accessible to the Indian company. The Indian company

accesses the CDN computer system of the applicant at Hong Kong. After having accessed the CDN, it establishes access to the CPU through the CDN. At both the stages, the Indian company is allowed to use the software developed and protected by the applicant company.

29. As is the practice in Canada, USA and other developed countries, allowing the use of protected software for a consideration by way of a contract amounts to income by way of royalties covered under art. 12(3)(a) of the DTAA.

30. Reference to Klaus Vogel's Commentary on Double Taxation Conventions (p. 787 , para 27) shows that in Canada, payment for using of software by virtue of contract, where the programme is kept confidential, amounts to payment for use of secret formula and hence amounts to royalty payment. A similar view is taken in United States as referred to in para 29 (p. 784) of the Commentary by Vogel which states as under :

"29. The United States believes that in interpreting the definition of 'royalties' in para 2 of the article, with respect to payments for software, it should be understood that where a payment for the acquisition of software for the personal or business use of the purchaser is measured by reference to the productivity or use of such software, the payment may represent a royalty under the article."

As to the definition of the expression 'royalty', reference may usefully be made to comments of the same author :

"In cases of concepts not having such a clear meaning under private law, an independent interpretation from an economic or taxation point of view might be somewhat more indicated." [cf. the terms used in art. 12(2) on the one hand and those used in art. 12(1), (3) and (4) on the other].

The term 'royalties' means :

—all payments

—made as a consideration

—for the use of (or the right to use)

—copyrights, industrial property rights, equipment and experience" (Vogel's Commentary on Double Taxation Conventions, p. 786).

31. It would appear that there are three main ingredients which partake of the character of royalty payment :

(1) It is a payment made in return for a right to exercise a beneficial privilege or right.

(2) The payment is made to the person who owns the right.

(3) The consideration payable is determined on the basis of the amount of use.

All these tests squarely cover the CPU and CDN charges payable by the Indian company.

32. It is quite clear that the applicant is aware of the taxability under the head 'royalty', but has raised the question whether the aforesaid payments fall under art. 12(3)(b) or whether they are taxable @ 20% for the first 5 years and thereafter @ 15% under art. 12(3)(a).

33. The answer to the above question has to be determined with reference to the facts and circumstances of this case mentioned above. We are moving increasingly towards a digital age. With increasing globalization, both labour and capital has become more mobile and markets more integrated and business being conducted across borders on a day-to-day basis. It is well-known that globally, enterprises are becoming completely **networked**, more so in the field of software. 'Y', in the present case, is a service-provider, which inter alia, allows the 'XT' to use its bandwidth as also its **networking**-infrastructure for the consideration spelt out in the agreement. In the instant case, though workers are less mobile than the capital and technology, the access to which has been made possible through the CPU and CDN.

34. Undoubtedly, there are millions of transactions which are integrated and processed at a very high speed and every transaction is accounted for in the books of accounts. For all intents and purposes, 'XT' not only collects the **data** regarding the use of travel documents by the applicant's clients in India and transmits it to the multi-locational electronic set up of the applicant, it also provides various other services such as sending daily and monthly record of bills and payments to its service establishments. On their own admission, after the billing of every card member is completed, the process of collection starts which is captured and recorded in the books. The information is also stored centrally in the CPU which is used by 'XT' to book receipts in ledgers. The ABC companies in the 13 countries also have transactions with over 500 banks, for which the mainframe system in USA is used by 'XT'.

35. 'XT' in its activities in India uses 500 intelligent terminals and employs over 500 foreign trained personnel who not only use input and output **data**, they also use software and conduct **data** management and information analysis on an online basis. In fact, that is their only income from services as seen from the P&L a/c. The definition of the expression 'royalty' under s. 9(1)(vi) of the IT Act, 1961, and Explan. 2(vi) includes rendering of any services in connection with any activities for the use of patent invention, secret formula or process, etc. Hence, the concept of "source" as 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, source rule becomes relevant which requires that the royalty is sourced in the State of the payer.

36. As per the Agreement, the facilities are to be accessed only by 'XT'. The consideration payable is for the specific programme through which 'XT' is able to cater to the needs of ABC companies located in Japan, Asia Pacific, Australia and New Zealand. Reference to Klaus Vogel's Commentary referred to earlier would support the view that the transaction would relate to a 'scientific work' and would partake of the character of intellectual property. Relevant paras from Vogel's Commentary at p. 783 are reproduced below :

12. "(Consideration for software) Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development computer technology in recent years and the extent of transfers of such technology across national borders. Software may be described as a programme, or series of programmes, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing, on a magnetic tape or disc, or on a laser disc. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware. The rights in computer software are a form of intellectual property. Research into the practices of OECD Member countries has established that all but one protect software rights either explicitly or implicitly under copyright law. Transfers of rights occur in many different ways ranging from the alienation of the entire rights to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it

difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment.

13. (Three types of software transfer) Three situations are considered. The first is of payments made where less than the full rights in software are transferred. In a partial transfer of rights the consideration is likely to represent a royalty only in very limited circumstances. One such case is whether the transferor is the author of the software (or has acquired from the author his rights of distribution and reproduction) and he has placed part of his rights at the disposal of a third party to enable the latter to develop or exploit the software itself commercially, for example by development and distribution of it. It should be noted that even where a software payment is properly to be regarded as a royalty there are difficulties in applying the copyright provisions of the article to software royalties since para 2 requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt but treatment as a scientific work might be the most realistic approach."

37. In this connection, a useful reference could also be made to the revision of the commentary on art. 12 concerning payments for use of software where paras 12-17 were added in 1992 as a consequence of the Committee on Fiscal Affairs' Computer Software Report. Therefore, the treatment of the aforesaid transaction has to conform to the revised commentary to accommodate the emerging developments relating to computer software (Philip Baker's Double Taxation Conventions and International Tax Law—2nd Edition p. 272). The trend of discussion clearly indicates that the payments received in such transactions are for the use of intellectual property and partake the character of royalty.

38. The applicant is using client service technology. The **data** is collected in India and, admittedly, due to appreciable volume of work the American concern is providing services under consideration. The income is arising in India and is taxable as 'royalty' under art. 12(3)(a). The software being used is specifically developed by the applicant company under an agreement signed in 1994 and renewed in 1997. The software is customised and secret. This clearly flows from para 3 of the letter of the applicant dt. 22nd July, 1998 (cited in para 28 above) that the CPU has its own software belonging to the applicant. From the facilities provided by the applicant to the Indian company, which are in the nature of online, analytical **data** processing, it would be quite clear that the payment has been received as "consideration for use of, or the right to use.....design or model, plan, secret formula or process....." within the meaning of the term 'royalties' in art. 12(3)(a). From the question raised by the applicant, it seems that applicant is aware of the taxability of the payment received under the head 'royalty', but it has also raised the question whether the aforesaid payment could be covered under art. 12(3)(b), which speaks of "payment of any kind received as consideration for the use of or the right to use any industrial, commercial or scientific equipment". If the case of the applicant, falls under the aforesaid art. 12(3)(b), the gross payment would be taxable @ 10%. If it falls under art. 12(3)(a), the gross payment would be taxable @ 20% for the first five years and thereafter @ 15%.

39. In our opinion, the use by 'XT' of CPU and CDN of the applicant is not merely use of equipment as envisaged in art. 12(3)(b) of the DTAA but is more than that. From the transactions of the applicant with the Indian company as set out in para 6 above, it is quite clear that CPU/CDN of the applicant are modern technological designs or models involving customised communication and computation with application of sophisticated information technology requiring constant upkeep and updating so as to meet the challenge of the advance of technology in this area. It is the use of embedded secret software (an encryption product) developed by the applicant for the purpose of processing raw **data** transmitted by 'XT' which clearly falls within the ambit of art. 12(3)(a) of the DTAA. In the instant case, the precise amount of royalty to be paid by 'XT' is calculated on the basis of time taken by the CPU in processing the **data**. It is well-known that the rate of royalty can be either fixed or subject to variations depending on certain parameters, as, for example, the time taken in processing the **data** as in this case. Accordingly, the payment received by the applicant is liable to tax in India as 'royalty' in terms of art. 12(3)(a) of the DTAA. The Authority, therefore,

answers the questions raised as under :—

Ruling

Questions	Answers
(1) Whether payment due to the applicant under the transaction mentioned in Annexure B is liable to tax in India ?	Yes.
(2) If the answer to the question No. 1 is in the affirmative, whether the payment due to the applicant under the transaction mentioned in Annexure B is covered under art. 12(3)(a) or art. 12(3)(b) of the DTAA between India and USA ?	The transaction would be covered by art. 12(3)(a) of the DTAA between India and USA.

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