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Tax alert: Payments by Indian customers towards cloud computing fees not taxable as royalty under India–US DTAA

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Summary

The Mumbai Tribunal (ITAT), in a recent case[1], held that the payment received by a US company from Indian customers in respect of cloud computing services will not constitute 'royalty' under the India-US tax treaty (tax treaty). The ITAT also held that the retrospective amendment to the definition of royalty[2] under the Income Tax Act, 1961 (Act) would not override the provisions contained in the tax treaty.

Facts of the case

- The taxpayer, a cloud computing company incorporated in USA, is engaged in providing cloud hosting and data warehousing services to customers in India.
- The taxpayer claimed that income earned from Indian customers is in respect of the business income and not taxable in India in the absence of a Permanent Establishment (PE).
- The tax officer treated the income from cloud hosting services as royalty under the Act as well as under the tax treaty[3].
- The first appellate authority upheld the tax officer's order. Aggrieved, the taxpayer filed an appeal before the ITAT.

Revenue's contention

- The Revenue argued that Finance Act 2012[4] clarified that the payments for use of right, property or information would be considered as royalty irrespective of whether the possession and control of the right, property or information is with the payer.
- The agreement has been entered into between the taxpayer and customers for using the data center and availing other specialised services, and the customer gets the right to use the industrial/ commercial/ scientific equipment. Hence, payment for use should constitute Royalty under the Act[5].
- The Revenue contended that the decisions rendered on the basis of possession, control or location of the right, property or information, prior to retrospective amendment in the definition of royalty will not be applicable in the instant case and have no binding precedent value.
- Relying on the judicial precedents[6], it was held that the said payments constitute

1 Rackspace, US Inc vs DCIT (ITA No 1634/Mum/2016 and ors)
2 Explanation 4, 5 and 6 inserted for section 9(1)(vi) in Finance Act 2012
3 Under Article 12(3) of India-US DTAA
4 Under section 9(1)(vi) of the Act
5 Verizon Communication Singapore Pte Ltd. v. ITO, International Taxation-I [2014] 361 ITR 575 (Madras HC)
6 DCIT (IT), Mumbai v. Reuters transactions services Ltd [2018] 96 taxmann.com 354 (Mumbai - Trib.); Viacom 18 media Pvt. Ltd. v. ACIT [2015] 62 taxmann.com 74 (Mumbai – Trib.); Poompuhar Shipping Corporation Ltd. v. ITO, International Taxation -

royalty under the Act as well as India US tax treaty.

Taxpayer's contentions

- The amendment in the Act cannot be read into the tax treaty to determine the nature of payment as Royalty under the tax treaty.
- The Indian customers did not possess any control over the server or equipment and were only availing services.
- With regards to the rationale for introducing the amendment, the taxpayer contended that the same was done to remove conflicting views on location/ possession/ control/ delivery/ use of the royalty rights etc. by the user in India.

ITAT's observations and decision

- The ITAT stated that royalty as defined[7] under the Act includes payment for use or right to use an industrial, commercial or scientific equipment.
- The ITAT observed that the customers would only avail hosting services and do not use, possess, or control the equipment used for providing hosting services which is ultimately owned and controlled by the taxpayer.
- The ITAT clarified that retrospective amendment in the definition of royalty brought within its purview any payments made for the use of equipment irrespective of the possession or control or location of the equipment under the Act. However, the taxpayer can choose the tax treaty provisions to the extent that they are more beneficial than the provisions of the Act.
- The ITAT held that the definition of royalty under the tax treaty is exhaustive and not inclusive, and therefore it has to be given the meaning contained in the article itself and no other meaning should be ascribed to it.
- Thus, the ITAT held that the payments received from Indian customers cannot be construed as royalty since the customers do not possess control over the property or server. There is no agreement to hire or lease out any equipment but it is only a service agreement.
- With regards to the amendment in the Act, the ITAT held that in the absence of a corresponding change in the definition of royalty in the tax treaty, the retrospective amendment under the Act would not impact the tax treaty.
- Thus, the ITAT concluded that the income earned by the taxpayer from Indian customers for rendering cloud computing services do not constitute royalty under the India-US tax treaty.

II, Chennai [2014] 360 ITR 257 (Madras High Court), Verizon Communication Singapore Pte Ltd. v. ITO, International Taxation-I [2014] 361 ITR 575 (Madras High Court)

7 Under section 9(1)(vi) of the Act

Our comments

The issue of income characterisation in e-commerce transactions has become extremely significant in the Indian context with the tax authorities, in several cases, taking a position that the income received by foreign service providers for various e-commerce models is in the nature of 'royalty' or 'Fees for Technical Services' (FTS), both under the Act as well as under the tax treaty.

This ruling reiterates the position that payment in respect of web hosting charges to a non-resident will not constitute royalty under the India-US tax treaty. It also reaffirms that the retrospective amendment to the definition of 'royalty' under the Act will not override tax treaty provisions.

It is however, important for the taxpayers to carefully analyse the facts of each case along with the provisions of the Act and relevant tax treaty to determine the tax implications of such transactions.

Contact us

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NEW DELHI National Office Outer Circle L 41 Connaught Circus,New Delhi 110001 T +91 11 4278 7070	**NEW DELHI** 6th floor,Worldmark 2, Aerocity,New Delhi – 110037 T +91 11 4952 7400	**AHMEDABAD** 7th Floor, Heritage Chambers, Nr. Azad Society, Nehru Nagar, Ahmedabad - 380015	**BENGALURU** 5th Floor, 65/2, Block A, Bagmane Tridib, Bagmane Tech Park, C V Raman Nagar, Bengaluru – 560093 T+91 80 4243 0700	**CHANDIGARH** B-406A, 4th Floor, L&T Elante office Industrial area, Phase-I, Chandigarh 160002 T +91 172 4338 000
CHENNAI 7th Floor, Prestige Polygon 471, Anna Salai, Teynampet Chennai - 600 018 T +91 44 4294 0000	**DEHRADUN** Suite 2211, Michigan Avenue,Doon Express Business Park, Saharanpur Road, Dehradun – 248002T +91 135 264 6500	**GURGAON** 21st Floor DLF SquareJacaranda Marg,DLF Phase II,Gurgaon 122002 T +91 124 462 8000	**HYDERABAD** 7th Floor, Block III White HouseKundan Bagh, Begumpet Hyderabad 500016 T +91 40 6630 8200	**KOCHI** 7th Floor, Modayil Centre Point, Warriam road junction, M.G. Road, Kochi 682016 T +91 484 406 4541
KOLKATA 10C Hungerford Street5th Floor, Kolkata 700017 T +91 33 4050 8000	**MUMBAI** 16th Floor, Tower IIIndiabulls Finance Centre SB Marg, Elphinstone (W) Mumbai 400013 T +91 22 6626 2600	**MUMBAI** 9th Floor, Classic Pentagon, Nr Bisleri, Western Express Highway, Andheri (E)Mumbai 400099 T +91 22 6176 7800	**NOIDA** Plot No. 19A, 7th Floor Sector – 16A, Noida 201301 T +91 120 4855 901	**PUNE** 3rd Floor, Unit No 309 to 312, West Wing, Nyati UnitreeNagar Road, Yerwada Pune- 411006 T +91 20 6744 8800

For more information or for any queries, write to us at **contact@in.gt.com**

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