Tax Hotline

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PAYMENTS TO A UAE ENTITY FOR PURCHASE OF TECHNICAL KNOW-HOW NOT TAXABLE IN INDIA – HOLDS AHMEDABAD TRIBUNAL

- Payment for purchase of technical know-how does not constitute 'royalty'
- If there is no clause for FTS in the relevant tax treaty, then such payments should qualify as 'business income' not chargeable to tax in India in the absence of a PE.

The Ahmedabad Income Tax Appellate Tribunal ("**ITAT**") has recently contributed to the body of jurisprudence which holds that (i) payment for purchase of technical know-how in the form of designs / technical drawings does not constitute 'royalty'; and (ii) if there is no clause for fees for technical services ("**FTS**") in the relevant tax treaty, then such payments should qualify as 'business income' not chargeable to tax in India in the absence of a PE.[1]

Facts

Kalpataru Power Transmission Ltd. (the "**assessee**") is an Indian company engaged in the business of providing engineering, procurement, and construction ("**EPC**") services relating to infrastructure facilities comprising high power transmission line, transmission and distribution, laying of oil and gas pipelines etc. to its clients globally. The issue arose in respect of an EPC contract awarded to the assessee by a Chinese entity for erecting a transmission line in Uganda. For the purposes of erecting the transmission line in Uganda, the assessee (through its branch office in Uganda) obtained the services of Oil Stone Technologies, a company set up in the United Arab Emirates (UAE) – ("**service provider**") for carrying out project specification studies, preparation of tower designs, preparation of structural drawings of towers, etc. ("**Agreement**").

The services (under the Agreement) did not include granting any licenses to use any existing designs or data; instead, it involved the rendering of services to create new designs as per the specifications given by the assessee. The deliverables (i.e., the design, data, etc.) were to be used by the assessee in rendering its own EPC services to its client. As per the Agreement between the service provider in UAE and the assessee, the exclusive ownership over the designs created through the course of its services, and all rights therein, belonged to the ultimate customer (i.e., in the entities of Uganda).

AO

The Assessing Officer ("**AO**") found that the payments made by the assessee to the service provider in UAE were in the nature of 'royalty' as defined in Explanation 2, Section 9(1)(vi) of the Income tax Act ("**ITA**") and hence liable to withholding tax in India.

CIT(A)

On appeal, the CIT(A), ruled in favor of the taxpayer on two counts:

(i) At the first level, since the Agreement was for the service of generating new designs and not for grant of right to use an existing design, the payments couldn't be regarded as royalty. As such, the CIT (A) held that the Agreement was for contract of service and not a royalty contract.

(ii) Further, with respect to taxability of payments as FTS, the CIT(A) held that since the services were provided by a non-resident UAE entity to the assessee outside of India and that the services were utilized for the purposes of business of the assessee outside of India (i.e. Uganda), the case of the assessee was covered by the exclusion in clause of section 9(1)(vii)(b) as per which payment of FTS by a resident to a non-resident, for services utilized by the resident payor outside India, or for the purposes of earning income from sources outside India, is not taxable in India.

ITAT

Interestingly, while the ITAT arrived at the same conclusion of payments being non-taxable in India, its reasoning was slightly different than that of the CIT (A). At the outset, the ITAT agreed with the CIT(A) that since the payments were made for obtaining the services of creation of new design and not the granting of right to use in an existing design, it did not qualify as 'royalty'. Insofar as the taxation under the head of FTS is concerned, the ITAT held that in the absence of the FTS clause in the India – UAE Double Taxation Avoidance Agreement ("**India – UAE DTAA**"), the payment shall be treated as 'business income' not chargeable to tax in India in the absence of a PE. The ITAT noted that this is well settled law pronounced in a variety of rulings.[2]

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This ruling has delved into two interesting issues, i.e. (i) classification of payments made for purchase of technical know-how as 'royalty' or FTS; and (ii) taxability of FTS in the absence of the FTS clause in the relevant tax treaty.

With respect to the first issue, reference may be made to the Himachal Pradesh High Court judgment in CIT v. Maggronic Devices[3]. In this case, the Indian assessee had purchased the technical know-how from a Singapore company in the form of technical and engineering data, design data, drawings, sketches, photographs etc. The court held that the payment for purchase of the technical know-how did not constitute 'royalty'. The primary reasoning of the Court was that it was a case of outright purchase of know-how and not a case of transfer of interest. Similarly, the Andhra Pradesh High Court in CIT v. Klayman Porcelains Ltd.[4] held that payment for drawings, sketches, designs etc. should not constitute 'royalty'. As such, the current ruling seems to be aligned with the precedents in this regard.

As also asserted in the ruling, precedents exist even with respect to the conclusion on the second issue, i.e. in the absence of an FTS clause in the relevant tax treaty, FTS should be treated as business income, not taxable in India in the absence of a PE.

It would have been interesting to see the ITAT opining on the analysis of the CIT (A) (i.e. since the services were provided by a non-resident UAE entity to the assessee outside of India, and that the services were utilized for the purposes of business of the assessee outside of India (i.e. Uganda), the case of the assessee was covered by the exclusion clause of section 9(1)(vii)(b), and not taxable in India). This seems to be a plausible argument to conclude that the FTS paid by the assessee should not have been taxable in India. In-fact, the same argument could have also been made for 'royalty' in light of section 9(1)(vi)(b) which states that 'royalty' payable by a resident to a non-resident for the purposes of using the 'right to use' outside India, or for the purposes of earning income from sources outside India should not be taxable in India.

In this context, while the ruling and reasoning of the Court is sound, it could have further substantiated its rationale by concluding that even if the payments did constitute 'royalty', and the FTS clause did exist in the India- UAE DTAA, the payments should still not have been taxable in India, in light of the exclusionary clauses of 'royalty' and 'FTS' discussed above.

– Arijit Ghosh & Afaan Arshad

You can direct your queries or comments to the authors

[1]DCIT vs Kalpataru Power Transmission Ltd (ITA No. 35/Ahd/202)

[2]ABB FX LLC vs ITA 75 taxmann.com 83 (Bang – Trib); Paramina Earth Technologies Inc. vs DCIT 116 taxmann.com 347 (Vishakhaptnam – Trib); DCIT vs TVS Electronics Ltd 22 taxmann.com 215 (Chennai); DCIT vs IBM India (P) Ltd 100 taxmann.com 230 (Bangalore – Trib); Booz and Company (ME) FZ-LLC vs DDIT 90 taxmann.com 49 (Mumbai – Trib.).

[3][2010] 190 Taxman 382 (Himachal Pradesh).

[4][1998] 229 ITR 735.

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