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INCOME FROM CLOUD HOSTING SERVICES NOT TAXABLE AS 'ROYALTY' HOLDS TAX TRIBUNAL

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Introduction

The Income Tax Appellate Tribunal (ITAT) recently held that income from cloud hosting services provided by a company based in the United States of America to its Indian customers was not 'royalty' or 'Fees for Technical Services' (FTS) under the India - USA Double Taxation Avoidance Agreement (Treaty). The same constituted business income which was not taxable in India in the absence of a Permanent Establishment (PE).

Facts

Rackspace, US Inc (Taxpayer), is a company incorporated in and a tax resident of USA. The Taxpayer earns income from cloud services including cloud hosting and other supporting, ancillary services provided to Indian customers.

For the years in question, the Taxpayer did not file tax returns in India. However, certain transactions of the Taxpayer were available in a tax database maintained by the income tax authorities. Basis this information, the tax officer was of the view that income of the Taxpayer had escaped assessment and proceedings under the Income-tax Act, 1961 (IT Act) were initiated against the Taxpayer.

The tax officer and dispute resolution panel (DRP), which is a body engaged in resolving disputes by way of alternative dispute resolution mechanism, opined that the Taxpayer's income from the aforementioned services was taxable in India as royalty and FTS, both under the IT Act and the Treaty. The Taxpayer on the other hand claimed income from these services to not be taxable as either royalty or FTS.

As per Section 90(2) of the IT Act, a Taxpayer can choose to be governed either by the provisions of the IT Act or the Treaty, whichever is beneficial.

Under the IT Act, the definition of royalty includes within its scope any payments made for the use of equipment, irrespective of whether the possession or control of the equipment was with the customers in India. Under the Treaty however, the definition of royalty is narrower, and a payment would classify as royalty only if it is received as consideration for the use, or right to use, any industrial, commercial or scientific equipment.

The Taxpayer claimed that the payments received by it did not constitute royalty under the Treaty since the Indian customers did not operate the equipment or have physical access to or control over the equipment used by the Taxpayer to provide services. Further, the Taxpayer claimed that it did not make available any technical knowledge, experience, skill or know-how to its Indian customers, and neither were the services in the nature of managerial, technical or consultancy services to constitute FTS under the Treaty.

Decision of the ITAT

The ITAT ruled in favour of the Taxpayer, largely relying on the ITAT's decision in the Taxpayer's own case in the previous years. The key findings in the ITAT decisions put together were as follows:

- *Distinction between definition of royalty under the IT Act and Treaty*: The ITAT noted the distinction between the definition of royalty under the IT Act and the Treaty. The ITAT remarked that the definition of royalty under the Treaty was an exhaustive and not inclusive definition and the definition under the IT Act or amendments made thereto cannot be read into the Treaty. As for the definition under the Treaty, the ITAT was of the view that the word(s) 'use' or 'right to use' entails that the payer has possession/ control over the property and/ or that the said property is at its disposal. Since this was not the case with the Taxpayer's customers, the payment could not be categorised as royalty.

- *No control over equipment or servers*: The ITAT noted that the Taxpayer only provided cloud hosting services and did not give any equipment or control over the equipment or servers to its Indian customers. The infrastructure and servers vested solely with the Taxpayer and the Indian customers were unaware even of the specific location of the server. The Taxpayer exclusively had the right to operate and manage this infrastructure/server and the contract was purely for services.

- *Beneficial definition under Treaty*: Basis the definition of royalty under the Treaty (which is narrower and hence beneficial from the Taxpayer's perspective), the ITAT held that the definition of royalty or FTS did not encompass payment received by the Taxpayer for the services the Taxpayer provided.

Comments

In its decision, the ITAT has reiterated a simple yet fundamental principle of tax law, i.e., of giving precedence to the beneficial provisions of a tax treaty over the IT Act. It has in clear words emphasised on the importance of refraining from reading provisions of domestic law into tax treaties, thus safeguarding the rights of taxpayers.

While this is a welcome ruling for the cloud hosting business models, it also indicates how the tax officer might be viewing such arrangements. From an Indian tax perspective, litigation on issues like these where the taxpayers contend that the payments are neither in the nature of royalty nor FTS and therefore, should not be taxable, is common. The introduction of equalization levy of 6% (six percent) on payments made to non-residents towards online advertisements and related services was one of the steps taken by the government to address this issue partly – interestingly this domestic law provision is not subject to the beneficial provisions of a tax treaty. Given the way the business models are evolving and the global consensus on updating

tax laws to address the issue of base erosion, one should keep a close watch on these developments.

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