Tax Insights

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Mere access to server located abroad to obtain reports is not taxable as royalty – Delhi bench of the Tribunal

In brief

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal)[1] rejected the Tax Officer's (TO) contention that payments made for obtaining candidate reports by accessing the server located outside India are taxable as royalty. The Tribunal concluded that mere access to use the server or software to download the reports does not tantamount to transfer of any license or copyright in the software such that it is covered within the purview of Article 13 of the India-UK Double Taxation Avoidance Agreement (DTAA).

The taxpayer is engaged in the business of training pilots and providing services for assessing pilot candidates. For rendering its services, it entered into a contract with a non-resident for evaluating and profiling candidates being trained for piloting. The non-resident provides candidate profiling services by utilising their UK-developed and maintained software.

The taxpayer is given access to the software merely to download the reports, which are in the form of copyrighted articles. The Tribunal observed that the taxpayer had not been granted any right of commercial exploitation of the software; therefore, the payment was not taxable as royalty.

In detail

Facts

- The taxpayer is a private limited company engaged in the business of training pilots as well as providing services in relation to the assessment of pilot candidates for its customers.
- The taxpayer has entered a contract with a non-resident for the purpose of evaluating and profiling candidates being trained by the taxpayer and providing reports thereafter.
- In the course of assessment proceedings, the TO, in addition to an adjustment on account of claim of depreciation @60% on CISCO IP Phones, also made disallowance under section 40(a)(i) of the Income-tax Act, 1961 (the Act) in respect of the payment made to the non-resident.

[1] ITA No. 2573/Del/2022

- With respect to the payment being considered as royalty, the TO made the following observations in the assessment order:
  - The non-resident provides these services from their registered office in the UK using the servers running the software located in the UK;
  - The reports generated by the non-resident are exported to India, and no software is run or installed on the taxpayer's system;
  - The customised online questionnaire is developed to support the candidate selection and assessment process. This test is software-based and uses a custom algorithm which makes the software a custom-made software specifically developed for the clients;
  - A new algorithm and report template are built for every report, and the resulting reports are charged on a per report basis. Thus, the payment made for making a customised template or algorithm from the software is a payment in the nature of royalty;
  - A set of licenses can be purchased from the non-resident after which each candidate is allotted a license key specific to the assessment programs. This clearly establishes that each set is sold as a license which gives the user the right to use the intellectual property of the non-resident; therefore, the payment is in the nature of royalty.

Taxpayer's contentions

- The taxpayer is neither granted the right to control any equipment, network, infrastructure etc. nor any right to modify the source code. All the access rights for any application software are available only with the non-resident.
- The taxpayer is not granted the right of commercial exploitation of the intellectual property or software.
- The title or ownership and proprietary rights to the systems and software, and the copyright in the software are owned by the non-resident and will remain with it.
- The software used for preparing the report is located, owned and managed outside India.
- The taxpayer only receives a report which contains the details of the candidate's score against the measured attributed and provides an overall assessment of the performance of the candidate against a given syllabus or training profile; therefore, the payment cannot be treated as 'royalty'.
- The taxpayer contented that the issue of claim of deprecation had been already covered in the taxpayer's case for assessment year (AY) 2016–17. It was held that items which are functionally dependent on computers and are not used independently of computer systems will be treated as computers. Whenever these are used independently for any other purpose, they will be treated as plant and machinery.

Tribunal's observations and ruling

- The taxpayer has mere access to the server or software to download the reports. The candidate's report is delivered to the taxpayer electronically, which is in the nature of copyrighted product. There is no transfer of any license or copyright in the software; thus, it is not covered within the definition of 'royalty' under Article 13 of the India-UK DTAA.
- The software or application is owned and executed by the non-resident in its server located in UK, and the taxpayer merely gets the copyrighted article to use the product for its internal business purpose and not for any right to exploit the same for commercial reasons.
- Support is drawn from the decision of the Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited[2]. The non-resident is solely testing the ability of the candidate as per the parameters or standards of the taxpayer so as to ascertain whether the candidates meet the quality or performance criteria of the taxpayer.

[2] Engineering Analysis Centre of Excellence Private Limited *v.* CIT [2021] 125 taxmann.com 42 (SC)

- Thus, the payment received in consideration does not constitute royalty in terms of Article 13 of the India-UK DTAA.
- In case of the disallowance of the depreciation claim, the Tribunal agreed to the taxpayer's contention and directed to follow the Tribunal's order in taxpayer's own case for earlier years.

The takeaways

Mere access to use the server or software to download the reports cannot be regarded as transfer of any license or copyright in the software and is not covered within the definition of royalty. What needs to be seen is whether access to the software equipment of the non-resident entity is given to the taxpayer such that there is transfer of title or ownership and proprietary rights to the systems and software of the non-resident. Moreover, where the business income of the non-resident is not chargeable to tax in India in the absence of a permanent establishment, there will be no liability to deduct tax at source.

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