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Tax Insights

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Receipts from cloud-computing services not taxable as royalty, FTS or FIS as per the India-USA DTAA – Delhi bench of the Tribunal

In brief

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal)[1] was of the view that receipts from cloud-computing services are not taxable as fees for included services (FIS), as they do not satisfy the 'make available' clause under Article 12(4)(b) of the India-USA Double Taxation Avoidance Agreement (DTAA). Moreover, the receipts are also not taxable as 'royalty' under the provisions of Article 12(3) of the India-USA DTAA.

In detail

Facts and issue

- The taxpayer, a tax resident of USA, provides cloud-computing services to customers worldwide. The taxpayer enters into customer agreements with its Indian customers to provide cloud-computing services.
- The TDS wing brought to the tax officer's (TO) attention that the taxpayer had received payments from Indian customers on which no tax has been deducted and no return of income has been filed by the taxpayer. Accordingly, the TO initiated proceedings under section 147 of the Income-tax Act, 1961 (the Act) in the taxpayer's case and treated the receipts from cloud-computing services as 'royalty' as well as FIS or fees for technical services (FTS) under both the Income-tax Act, 1961 (the Act) and the India-USA DTAA.

Revenue's contentions

Taxability of cloud-service fee as 'royalty'

- As per the trademark guidelines, the taxpayer provides its copyright and trade or service marks to its customers for commercial exploitation; moreover, it shares information concerning industrial, commercial and scientific experience with its customers.
- The fee received by the taxpayer is essentially towards the use of hardware and infrastructure (e.g. the servers, software, data storage space, networking equipment and databases) as well as the tools and environment supporting the entire product-development cycle.

[1] ITA No. 522 & 523/ Del/ 2023

- In Article 12 of the India-USA DTAA, the two expressions 'use' and 'right to use' followed by the word 'equipment' indicate that there must be some positive act of utilisation, application or employment of equipment for the desired purpose. Revenue has relied on a ruling of the Authority for Advance Ruling[2] which observed that it is sufficient to access a particular segment of a larger system or use the capacity of the system to qualify as 'use'.

- Explanation 5 to section 9(1)(vi) of the Act specifically provides that to determine what constitutes royalty, possession or control of the equipment in India is not a relevant consideration. The legislature has made its view clear that even remote use of a right, property or information would constitute royalty.

- India's position on the OECD Model Tax Convention on income and capital has always been clear: India does not agree with the definition of royalty as provided in this model. Therefore, the definition of 'royalty' as provided in Explanation 5 to section 9(1)(vi) of the Act clearly demonstrates India's position on royalty, which must be read into the DTAA as well.

Taxability of cloud-service fee as 'FIS' or 'FTS'

- As per the support guidelines, the taxpayer provides experts to build up knowledge and expertise along with architectural guidance for the applications and solutions the customers develop and build. Moreover, the taxpayer provides highly trained engineers and experts who support and provide resolutions to the customers.

- The taxpayer also provides developer, business and expertise supports to its customers for the development and production of content.

- Thus, the taxpayer provides technical support services and makes available technology to its customers. Accordingly, the impugned receipts are taxable as FIS or FTS under both the Act and the India-USA DTAA.

Taxpayer's contentions

Non-taxability of cloud-service fee as 'royalty'

- Customers do not receive any exclusive or commercial right to use the copyrights involved in the cloud services. They merely get access of these services.[3]

- Customers are only granted a non-exclusive and non-transferrable licence to access these services. The source code is never shared with the customers.

- Customers do not have the right to commercially exploit the intellectual property of the cloud services. They cannot copy, modify, create or derivate work or reverse engineer any part of the software or platform.

- The taxpayer has granted only a limited, non-exclusive, revocable and non-transferable permission to use taxpayer's marks to the customer, to identify that said customer is using taxpayer's services for its computing needs. The customers pay only for what they use.

- The taxpayer maintains its infrastructure in a secure environment, and customers can access the standard facility *via* the internet as well as develop and run their own applications.

- Customers are themselves responsible for the development, operation, maintenance and use of their content while availing the cloud-computing services.

- Customers have the sole access to and authority regarding their content stored in their account. The taxpayer does not provide any dedicated space to the customers in India. Customers do not have possession or control of the equipment or infrastructure used for cloud-computing services.

- Customers are not aware of the nature, capacity or specifications of the equipment or server, or even on which exact equipment or server is their data or content stored.

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2 Dishnet Wireless Limited, *In re* [AAR No. 863 of 2010]

3 Engineering Analysis Centre of Excellence Private Limited *v.* CIT [2021] 432 ITR 471 (SC)

- Customers can only access the standard off-the-shelf software. They have neither any right or domain over any hardware nor any copyright of any software at any time.
- Regarding the taxability of cloud services as 'royalty', reliance has been placed on the Tribunal's ruling in the case of Microsoft Regional Sales Pte. Ltd, which has been affirmed by the Delhi High Court[4].
- Reliance is also placed on rulings[5] which held that the payments Indian customers have made to the taxpayer for the use of cloud-computing services are not taxable as royalty.
- The retrospective amendment made in section 9(1)(vi) of the Act through the insertion of Explanation 5 thereto cannot be read into the DTAA.
- Mere positions taken with respect to the OECD Commentary do not alter the DTAA provisions, unless the DTAA is actually amended through bilateral renegotiation.

Non-taxability of cloud-service fee as 'FIS' or 'FTS'

- The cloud-computing services provided by the taxpayer are standardised and automated services.
- Moreover, the troubleshooting and support services provided by the taxpayer are general support services, which do not involve any transfer of technology or knowledge. These are merely incidental services provided to the customers to enable them to use the cloud services effectively.
- The support service guidelines specifically mention that the technical services the taxpayer provides under these guidelines do not include code development, debugging, administrative tasks, etc.
- The taxpayer's content and documentation are similar to a user manual that guides customers in using the cloud services.
- The taxpayer neither provides technical services to its customers nor satisfies the 'make available' clause as mentioned in Article 12 of the India-USA DTAA. This is because the customer cannot make use of the technical knowledge, skill, process, etc. the taxpayer has used in the cloud-computing services by itself.
- In the context of a similar cloud-computing services the Pune bench of the Tribunal[6] was of the view that cloud services are not taxable as FIS in the absence of a 'make available' clause under Article 12(4)(b) of the India-USA DTAA.
- Moreover, the Mumbai bench of the Tribunal[7] was of the view that rendering of cloud-computing services cannot be liable to tax in India as FTS.

Tribunal's ruling and observations

A. Taxability of the cloud-service fee as 'royalty' under the India-USA DTAA

- Customers do not receive any right to use the copyright or other intellectual properties involved in these services. They are granted only a non-exclusive and non-transferrable licence to access the standard automated services the taxpayer offers.
- Customers are not granted any source code of the licence. They do not have any right to use or commercially exploit the intellectual property.
- The taxpayer has placed no equipment at the disposal of the customers.
- Customers have been granted only a limited, non-exclusive, revocable and non-transferable right to use the taxpayer's marks to identify customers who are using taxpayer's services for their computing needs.

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4 CIT *v.* Microsoft Regional Sales Pte.Ltd.[99/2023dated 16.02.2023 (Delhi)]

5 EPRSS Prepaid Recharge Services India Private Limited *v.* ITO [2018] 100 taxmann.com 52 (Pune-ITAT); Urban Ladder Home Decor Solutions Private Limited *v.* ACIT (IT) [IT (IT)A No. 615 to 620/Bang/2020]; Reasoning Global E-Application Limited *v.* DCIT [2022] 145 taxmann.com 464 (Hyd-ITAT)

6 ITO *v.* Sunguard Availability Services LLP [ITA No. 258/Pun/2021]

7 Rackspace, US Inc. *v.* DCIT [2020] 113 taxmann.com 382 (Mumbai)

- Various courts have dealt with this impugned issue.[8] On perusal of customer agreements similar to the one that the taxpayer has entered into with its customers, the courts have held that the payment is not covered under the purview of 'royalty'.
- Thus, receipts towards the cloud services are not taxable as 'royalty' under Article 12(3) of the India-USA DTAA.

B. Taxability of the cloud-service fee as 'FIS' under the India-USA DTAA

- Services the taxpayer has provided are merely standard and automated services that are publicly available online to anyone. These services are all standardised, and there is no customisation for any particular customer.
- Under the support service guidelines, only incidental or ancillary support is provided to the customers. These guidelines specifically provide that such technical support does not involve code development, debugging, etc.
- The support services are general and incidental support services that the taxpayer provides to its customers. They do not involve any transfer of technology or knowledge that enables the customers to develop and provide cloud-computing services on their own in the future; rather, they only enable customers to effectively access the taxpayer's services.
- The meaning of the term 'architectural guidance' as envisaged by the TO is totally misplaced, as it simply means providing guidance on how to use the taxpayer's products, features and services together, as well as providing guidance on optimisation and configuration of the taxpayer's services to meet customers' specific needs. Thus, such guidance in no way results in making available any technical knowledge or knowhow to the customers.
- Reliance is placed on the rulings of the Pune bench of the Tribunal in the case of M/s Sunguard Availability Services LLP[6] and Rackspace, US Inc[7]. Herein, the Tribunal was of the view that the cloud-computing service fees are not taxable as FTS or FIS.

The takeaways

This is a welcome ruling by the Delhi bench of the Tribunal. The Tribunal has affirmed the position that the provision of cloud services does not result in service providers granting the customers control or access to the infrastructure setup for the rendition of such services. This is a critical remark by the Tribunal, which will provide comfort to the industry players in forming a view of the true nature of the transaction. Moreover, the Tribunal opines that the cloud services are standard and automated services that are open to the public at large and are not customised for any particular service recipient.

The Tribunal has followed observations from the Supreme Court decision in the case of Engineering Analysis[3], even though the review petition against the said order remains pending before the Supreme Court. This provides additional comfort to the taxpayers as they can continue to follow the various principles the Supreme Court has laid down in the aforementioned decision.

The Tribunal's affirmation that the cloud-service fee does not qualify as royalty, FIS or FTS could also be helpful to other industry players or service recipients (to comply with their tax deduction obligations). Nevertheless, the equalisation-levy implications on such cloud-service transactions must be evaluated separately based on the specific facts of each case.

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8 EPRSS Prepaid Recharge Services India Private Limited *v.* ITO [2018] 100 taxmann.com 52 (Pune-ITAT); Urban Ladder Home Decor Solutions Private Limited *v.* ACIT (IT) [IT (IT)A No. 615 to 620/Bang/2020]; Reasoning Global E-Application Limited *v.* DCIT [2022] 145 taxmann.com 464 (Hyd-ITAT); Microsoft Regional Sales Pte. Limited *v.* ACIT [2022] 145 taxmann.com 29 (Delhi)

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