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What's New

Tax Insights

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Receipts towards testing services taxable as 'royalty', being consideration for sharing information concerning commercial and scientific experience – Delhi bench of the Tribunal

In brief

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal) ruled[1] that payments towards testing services qualify as royalty under Article 12(4) of the India–Netherlands Double Taxation Avoidance Agreement (DTAA). The Tribunal found that these services involve sharing scientific experience and knowledge, which enables the Indian entity to improve plant varieties and breeding programmes. Therefore, the Tribunal concluded the same to be information concerning industrial, commercial or scientific experience.

Additionally, the Tribunal concluded that reimbursements received for information technology (IT) support services are not taxable as fees for technical services (FTS) under the DTAA; this is because the payments are mere cost-to-cost reimbursements and do not satisfy the 'make available' test.

In detail

Facts

- The taxpayer is a Netherlands-based company engaged in improving vegetable varieties and vegetable value chain for its customers. During the year, the taxpayer earned receipts on the account testing and IT support services it rendered to its associated enterprise (AE) in India.
- As per the terms of the service agreement, for research and development (R&D) activities between the taxpayer and the Indian AE, the nature of the taxpayer's rendered services is to support the Indian AE's breeding programmes in India by providing marker analysis services and producing doubled haploids (DH).
- The testing services were performed at the taxpayer's R&D centre in the Netherlands. For testing, the Indian AE sent a sample of seeds and leaves for testing. The total duration for testing and sharing the results was 20–25 days.
- A DH is a genotype formed when haploid cells undergo chromosome doubling. DH technology enhances 'forward breeding' by allowing hybrids to be bred with new traits. As regards the DH services, the Indian AE sent seeds to the taxpayer for DH conversion. The taxpayer grew these seeds at its polyhouses until they became plants. As regards the DH services, the Indian AE sent seeds to the taxpayer for DH conversion. The taxpayer grew these seeds at its polyhouses until

[1] ITA No. 3382/DEL/2023

they became plants. It then extracted new seeds from the DH plants and sent them back to the Indian AE. The entire DH process typically spanned about 18 months.

- The taxpayer filed its return of income for financial year 2020–21 declaring nil taxable income. As per the return, it claimed both the receipts as non-taxable in India. The return was selected for regular assessment under section 143(3) of the Income-tax Act, 1961 (the Act).
- During the assessment, the tax officer (TO) treated the receipts from marker analysis and DH services as royalty. As per the TO, the taxpayer imparted its scientific experience to the Indian AE in the form of test reports, which are used as information to decide the industrial or commercial viability of the seeds. Additionally, the TO concluded that access to common software also amounted to the use or right to use the copyright and equipment, and consideration for the same is royalty.
- Furthermore, the TO considered receipts for the use of IT infrastructure to be FTS and added the same to the taxpayer's taxable income.
- Aggrieved by the draft assessment order, the taxpayer filed objections before the Dispute Resolution Panel (DRP). However, the DRP upheld the draft assessment order the TO had passed.

Taxpayer's contentions

- The taxpayer argued that the agreement with the AE was for providing services and not imparting technical knowledge, know-how or skill. Moreover, such services are routine in nature and are provided on a recurring basis. It did not make available any skill, knowhow, knowledge, experience, etc. known to the Indian AE to independently perform the technical function independently in the future without recourse to the taxpayer.
- In addition, the process of requesting tests for leaves and seeds and getting results through the common software, which is available to group entities, only involves limited use of a software license. It does not grant any copyright contained in the software.
- Regarding IT support services, the taxpayer contended that the services were rendered by a third party in Netherlands. The third party raised invoices on the taxpayer, and the taxpayer raised corresponding invoices (without any mark-up) on group affiliates of other countries to recover the IT support service cost. Therefore, the payments are pure cost-to-cost reimbursements without any markup or profit element. Moreover, as no technology or knowhow was made available to the Indian AE, it did not satisfy the 'make available' test, as required under Article 12(5) of the DTAA.

Revenue's contentions

- The Revenue contended that the taxpayer had provided information in the form of test reports to the Indian AE to improve plant varieties, achieving breeding progress by assessing external and internal traits. The Indian AE's breeding programmes depended upon such reports; thus, the reports have commercial significance. Accordingly, the test reports share scientific knowledge, experience, skill, etc. and receipts accruing out of such activities amount to royalty as per the Act and DTAA.
- As regards the IT support services, the Revenue contended that it is not a case of procuring services but of making available complete infrastructure to the AE, and the AE is charged on an actual usage basis. The taxpayer also maintains the IT infrastructure and charges a maintenance fee to the AE. Accordingly, the services rendered by the taxpayer to the Indian AE were covered within the definition of FTS under section 9(1)(vii)(b) of the Act and Article 12(5) of the DTAA.

Tribunal's ruling

- The Tribunal observed that, as per the agreement, the taxpayer is bound to mandatorily support the breeding programme in India, since it possesses all the technology and resources not available

with the Indian AE. Similarly, the DH testing imparts technology and knowledge to the Indian AE for 'forward breeding' by allowing the breeding of hybrids with new traits.

- The taxpayer's knowledge and scientific experience are directly linked to the conversion of an average seed the Indian AE has sent into a healthy DH seed. These seeds are created using a controlled scientific method to produce offspring with enhanced traits.
- Therefore, the Tribunal concluded that the report the taxpayer sent encapsulates all its scientific experience and knowledge, gleaned in the process of converting the ordinary seeds into DH seeds.
- Additionally, the Tribunal concluded that the amount the Indian AE paid is not merely to access the software; specifically, it has paid for the information contained in the marker analysis and DH production reports uploaded on said software. Therefore, the payment is for information and knowledge developed out of technology and scientific experience the taxpayer has imparted to the Indian AE.
- Accordingly, the Tribunal concluded that receipts for testing services qualify as consideration *'for information concerning industrial, commercial or scientific experience'*. Moreover, the Tribunal opined that the said consideration was covered under the definition of royalty as per Article 12(4) of the DTAA. Tribunal further clarified that Article 12(4) of the India-Netherlands DTAA nowhere provides that the condition of 'make available' be satisfied to determine a consideration to be covered under the ambit of 'royalty'.
- Regarding IT support reimbursements, the Tribunal observed that the third party provided the services and the taxpayer merely recovered actual costs from the Indian AE. It also concluded that each time the Indian AE faced IT issues, it could not solve the same independently. Accordingly, the taxpayer never 'makes available' any skills, knowhow, knowledge, experience, etc. to the Indian AE so that the latter can independently perform the technical function itself in the future, without the help of the service provider. Therefore, the payment does not qualify as FTS under Article 12(5) of the DTAA and is not taxable in India.

The takeaways

The Tribunal ruling reinforces an important principle regarding taxability of testing services by holding that such payments may be regarded as information royalty where the test reports do not merely provide the end result of application of scientific or technical knowledge but rather share the underlying experience that leads to the test results; or the technology or product developed through such tests, is actually shared with the service recipient for commercial use. The ruling makes a clear distinction between testing services that merely shares results and those that also convey the taxpayer's scientific expertise and experience through the test reports.

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