Payment Towards Cloud Hosting Services: Whether It Constitutes Royalty?

Kluwer International Tax Blog
February 21, 2020

Amrit Singh (Nirma University)

Please refer to this post as: Amrit Singh, 'Payment Towards Cloud Hosting Services: Whether It Constitutes Royalty?', Kluwer International Tax Blog, February 21 2020, http://kluwertaxblog.com/2020/02/21/payment-towards-cloud-hosting-services-whether-it-constitutes-royalty/

In my previous post, I had discussed the judgment delivered in the case of Elsevier Information Systems Gmbh v. Dy. Commissioner of Income Tax which discussed the liability of the taxpayer when it charges a subscription fee from the customers for rendering access to its database.

It seems that the Income Tax Department has still not clearly interpreted the law with respect to the aforementioned case. It is interesting to note that the Income Tax Appellate Tribunal ("hereinafter referred to as the **"Tribunal"**) in the case of Rackspace, US Inc. (**"taxpayer"**) v. DCIT (International Taxation) (**"DCIT"**) had to again clarify the same issue. So, as per the AO, the income received by the taxpayer from cloud services was royalty within the meaning of Explanation 2 to Section 9(1)(vi) of the Income Tax Act 161 (**"Act"**) and Article 12(3) of the India-US Tax Treaty (**"Treaty"**).

The taxpayer is a tax resident of USA and it earned income from cloud services during the assessment year (**"A.Y."**) 2010-11. The primary contention of the taxpayer was that the income earned was not taxable as royalties as per Article 12 because the customers never had physical access to or exercise any kind of control over the equipment which was used by the taxpayer to provide cloud services. Also, since the services rendered by the taxpayer were not in the nature of consultancy, managerial or technical services, the payment received was not fees as per the scope of Article 12 of the Treaty.

Further, it was argued by the taxpayer that the amount of revenue that was generated constituted business profits but in the absence of a Permanent Establishment (**"PE"**) in India as per Article 5 of the Treaty, the profits would not be taxable in India. Basically, Article 5 of the Treaty deals with the term "PE" and Article 5(1) states that the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Article 5(2) mentions the non-exhaustive list of things, by using the expression "includes", that can constitute a PE. Further, the latter part of the contention which states that the profits would not be taxable, was based on Article 7 of the Treaty. The relevant extract of Article 7 is as follows: "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."

As per the directions of the Dispute Resolution Panel, the DCIT held that the income earned by the taxpayer from rendering cloud support services was for use of or right to use industrial/commercial/scientific equipment constituted royalty according to Section 9(1)(vi) of the Act and Article 12(3)(b) of the Treaty.

Interestingly, the taxpayer had cited three decisions and in all those decisions, the assessee was the party against the revenue and the judgments of the ITAT in those matters were related to A.Y. 2012-13, 2013-14 and 2014-15.

The ITAT in the aforesaid judgments perused Section 9(1)(vi) of the Act and Article 12 of the Treaty. The major issue was related to the amendment that was brought about by Finance Act 2012 in the definition of the expression 'royalty'. So, the amendment introduced Explanation 4, 5 and 6 to Section 9(1)(vi) of the Act with retrospective effect from 1 June 1976.

The relevant amendment for our case is Explanation 5 which is as follows:

> *For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not-*
>
> > *a) the possession or control of such right, property or information is with the payer;*
> > *b) such right, property or information is used directly by the payer;*
> > *c) the location of such right, property or information is in India.*

So, this explanation basically states that the possession, control and location of the property would not be the relevant and determinative factors to find out if the income earned by the taxpayer is in the form of royalty or not.

Nevertheless, the ITAT also looked at Section 90(2) of the Act. The provision states as follows:

> *Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.*

As per this provision of the Act, the taxpayer being a tax resident of USA, was entitled to invoke the provisions of the Treaty. The ITAT then perused Article 12(3) and observed that the term 'use' or 'right to use' means that the payer possesses the property and it is at his disposal. It stated that the taxpayer had not provided any kind of right to the customers with respect to the equipment and that such equipments were not used by the customers but were used by the taxpayer to render cloud hosting services to its customers.

Hence, the ITAT in those cases held that the amendment brought about by the Finance Act 2012 cannot substitute the existing definition of the term 'royalty' under the Treaty and therefore the amendments would not impact the definition provided under the Treaty. So, the claim of the taxpayer was upheld by the ITAT.

Also, the ITAT in that case referred to its decision in the matter of Americal Chemical Society v. DCIT. In that case, the issue was with respect to the information provided by the taxpayer through journals. The ITAT held that the taxpayer only provides the access to view and search the articles that are present online and does not share its experiences and technology employed in evolving databases with the users. Further, it stated that the users do not get access to the rights of the articles available in the journal and that the right to replicate and reproduce did not vest with the users.

Therefore, in this case as well, the ITAT distinguished between a copyrighted article and copyright and held that the users had acquired the copyrighted article and not the copyright. Therefore, on the basis of this reason, it stated that the consideration paid for the copyrighted article is not a royalty.

In the present case of Rackspace, US Inc. v. DCIT (International Taxation), the ITAT observed that the customers did not have physical control or possession over the servers and that the right to operate and manage the infrastructure vested solely with the taxpayer. Moreover, the customers were not even aware of the specific location of operation of the server in websites, web mail etc. Hence, it held that the income cannot be categorised as royalty as per Section 9(1)(vi) of the Act and Article 12 of the Treaty. The ITAT also looked at the fact that since there was no PE in India, the question of taxing the income of the taxpayer does not arise and the ruling was in consonance with Article 7 of the Treaty.

Therefore, the tribunals should carefully look at the facts and circumstances of every case to find out if the taxpayer providing hosting services should be taxed or not. Further, another positive takeaway from the decision is that it applied the beneficial provision of the Treaty rather than bringing the retrospective amendment into application so as to offer protection to the taxpayer.