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Case Comment: Rackspace, US INC vs Dy. Commissioner of income tax (DCIT), Mumbai

Swaranjali Yadav[a]

[a]Amity Law School, Noida, India

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INTRODUCTION

Citation: ITA No. 1634/Mum/2016, ITA No. 1075/Mum/2017, ITA No. 3507/Mum/2017

Decided on: 29/05/2019

Bench: Sri Mahavir Singh, JM And Sri Rajesh Kumar, AM

Appellant: Rackspace, US Inc.

Respondents: The Dy. Commissioner of Income Tax (DCIT), (International Taxation)

FACTS OF THE CASE

The assessee provided cloud hosting services to Indian customers from his office in the US. Cloud hosting is when a network of servers is deployed to make applications and websites accessible to customers. In the absence of a permanent establishment in India, he (assessee)

claimed that the income disclosed (Rs. 29,49,01,258/-) by him should not be taxable in India. As a result, he requested a refund of Rs. 1,09,50,295/-.

However, the Assessing Officer held that the income earned by the assessee by offering hosting services in India was taxable in India and that it shall be dealt with as "royalty" under Section S. 9(1)(vi) of the Income Tax Act[1], 1961 and Article 12(3)(b) of the India-US Double Taxation Avoidance Treaty[2]. The assessee appealed before the Dispute Resolution Panel objecting to the order by the AO, but the DRP upheld the order. The issue is with respect to the payment of taxes for the financial years 2012-13, 2013-14, and 2014-15. The assessee has now approached the Income Tax Appellate Tribunal.

ISSUES

1. Whether income earned from cloud hosting services is "royalty" under explanation 2 to S. 19(1)(vi)[3] of the Income Tax Act, 1961 and Article 12(3)(b) of the India-US Double Taxation Avoidance Treaty.
2. Whether the cloud hosting services qualify as technical services in section 9(1)(vii)[4] of the Act and fees for included services under Article 12(4)(a)[5] of the DTAA.
3. Whether the order to pay the interest claimed under Section 234B[6] of the Act is incorrect.

ARGUMENTS BY THE APPELLANT

According to the appellant, the income earned from cloud hosting services should not be held to be "royalty". The appellant contends that it was incorrectly held that the hosting services provided by the assessee were basically just lending the right of use of the hardware, used by the assessee, to its customers and that the amount earned from such services should be considered as "royalty" under Section 9(1)(vi) of the Act and Article 12 of the India-US tax

[1] Income Tax Act, 1961, s 9
[2] India-US Double Taxation Avoidance Treaty, 1990, art. 12(3) (b)
[3] Income Tax Act, 1961, s 19(1) (vi)
[4] Income Tax Act, 1961, s 9(1) (vii)
[5] India-US Double Taxation Avoidance Treaty, 1990, art. 12(4) (a)
[6] Income Tax Act, 1961, s 234B

treaty. The Finance Act amended the definition of "royalty" in the year 2012. It was incorrectly held that the amended definition can be applied to the definition of "royalty" under Article 12 of the India-Us DTAA even though there was no amendment of the like in the document. The AO and the DRP made an erroneous conclusion that apart from the service as mentioned the assessee was also allowing access to third-party software to its clients which is also liable to be taxed. The appellant contends that the AO again erroneously held that the cloud hosting services were a form of technical services and will be covered under explanation (2) to clause (vii) of subsection (1) of section 9 of the Act and Article 12(4)(a) of India-USA DTAA. The appellant contends that the issues of the present case have already been decided in the case of ITO, Mumbai vs People Interactive (I) P Ltd.[7]wherein People Interactive who was the assessee in that case and owner of Shaadhi.com entered into a contract with Rackspace US to avail of their hosting services. Similar to this case, these services were also under consideration before the AO for the determination of tax issues. However, in that case, the AO held that the payment was not liable to be taxed in India either under Section 9(1)(vi) of the Income Tax Act or under the India- US tax treaty. In the same case, it was also held that all the hardware that was used to provide services to the People Interactive (who in that case was the customer of Rackspace) was in the control/ ownership of Rackspace and not located in India. The same case also made use of another case of Asia Satellite Telecommunications Co. Ltd. vs DIT[8] where again the nature of services provided by the appellant in that case to its customers was under question. The appellant, in this case, was the operator of satellites and the customers were the television channels. The Delhi High Court held that the satellite was under the control and operation of the operator and not the customers. Therefore, the court had held that the amount received for services rendered by Rackspace cannot be treated as "royalty".

For the third issue, the appellant contends that since the TDS has to be deducted at source by the payer under Section 195[9] of the Act there should be no interest levied under Section 234B of the Acton the payee if the payer fails to deduct the tax.

[7] *People Interactive (I) P. Ltd, v Department Of Income Tax* (2015)
[8] *Asia Satellite Telecommunications Co. Ltd. v DIT* (2011)
[9] Income Tax Act, 1961, s 195

ARGUMENTS BY THE RESPONDENT

The respondents made use of the terms and agreement of Rackspace, stating that it provides the use of third-party software to the customers and that the services provided by the assessee are technical. Further, according to the respondents, the assessee also provides access to hardware in exchange for money. They contend that the data center which contains all the hardware and servers for hosting services will qualify as "industrial/commercial/ scientific equipment" and the money received as "royalty" under Section 9(1)(vi) of the Act.[10] The servers or the data centers, according to their contention, are controlled by the customers. To further prove their point the respondents, take the example of the case of Verizon Communications Singapore[11]wherein it was held that the definition of "royalty" in India's tax treaty with Singapore should be construed in the same manner as the definition given in the Act. The definition of "royalty" in the tax treaty with Singapore is similar to that of the definition in the tax treaty with the USA. The court also provided clarification concerning the amendment to the Finance Act in 2012. According to the court, whenever the customer uses any "right/ information/ property" in exchange for monetary consideration irrespective of whether the operation of the assessee is in India or such "right/ information/ property" is in control of the customer, the consideration shall be treated as "royalty".the respondents also pointed out that the purpose of the amendment was to clarify the definition and not expand its scope. The same was also upheld in the case of Reuters Transactions Services Ltd.[12] which was also concerned with the tax treaty with the US. The respondent dismisses the relevance of Asia Satellite Telecommunications Co. Ltd. vs DIT[13]since its decision was pronounced before the amendment was introduced in 2012. Therefore, the respondent contends that the assessee's income is taxable in India.

[10] I Income Tax Act, 1961, s 9(1) (vi)
[11] *Verizon Communications Singapore v The Income Tax Officer* (2013) Tax Case (Appeal) Nos. 147 to 149 of 2011
[12] *Reuters Transactions Services Ltd.* (2016) Tax Appeal No.6384/2016
[13] Asia Satellite Telecommunications Co. Ltd. (n 8)

JUDGEMENT

The tribunal held that the monetary consideration paid by the customers is for the hosting services of the assessee and not for his hardware or equipment, therefore, the payment will not qualify as "royalty". The tribunal held that it was not for the "use or right to use an industrial, commercial or scientific equipment"[14] of customers. The customers were only utilizing the services provided by the assessee and not directly using the hardware. Concerning the amendment to the Finance Act in 2012, the tribunal further points out that even though the amendment states that, the payment shall be treated as "royalty", regardless of the fact that the customer is in possession of the hardware or if the equipment is stationed in India. However, the tribunal also pointed out Section 90(2)[15] of the Act which states that the assessee is allowed to go for the DTAA instead of the Act if it proves to be more favorable to him. Therefore, the assessee is allowed to be taxed under the DTAA. With respect to Article 12(3) of the DTAA, the tribunal held that the definition of "royalty" under the treaty is the same as that in the Act before the amendment. The tribunal held that the definition of "royalty" under Article 12(3) is exhaustive and only the definition given in the DTAA should be considered. The tribunal also held that the amendment in the Act will not affect the definition in the DTAA, which is still not amended. The tribunal supported this decision with the case of American Chemical Society vs DCIT[16] wherein it was held that the assessee only provided access to journals and did not hand over the possession of the database to the viewer. They were only allowed to search and view articles and the servers were located outside India. Therefore, payment for such a subscription did not qualify as "industrial, commercial or scientific". Similarly, the tribunal held that there was no use of any hardware of the Rackspace by the customers. Additionally, since the business is not carried out in India, they are also not taxable under the tax treaty. On the same ratio, the tribunal also held that the other ancillary services provided by the assessee were not technical in nature, as claimed by the respondent. Regarding the third issue also the court held in favor of the appellant.

[14] Income Tax Act, 1961, s 9
[15] Finance Act in 2012, s 90(2)
[16] *American Chemical Society v DCIT* (2017) Income Tax Appeal No. 6811/2017

COMMENTS: CONCLUDING REMARKS

With the increasing use of the internet, web hosting, cloud hosting services, etc. India needs to move in the direction of facilitating an enabling environment for such services to foster. Such companies should be protected from the problem of double taxation under the Income-tax Act and the tax treaty. This case proves to be a good example where both the AO and DRP had ruled in favor of taxing the cloud hosting services but the case was overturned by the ITAT. The decision is in the favour of protecting such nascent companies and start-ups from double taxation. As already mentioned above, the company was providing its services to big platforms like Shaadi.com in India, which means that the company had the potential to grow and encourage growth in the country. India and its courts should look at the bigger picture of the growth and development of India instead of clamping down on such companies. This case rightfully upholds that the customers are not in possession of the servers and since the assessee does not even have a permanent establishment in India, there is no case for taxing the assessee under the "royalty" provisions under the Act and the tax treaty. However, this should not be used by companies to avoid taxes in India. It is important to analyze each case carefully before reaching a decision.