

Basics of International Taxation

(Earlier known as “Aspects of International Taxation — A Study”)



Committee on International Taxation
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword to the Fourth Edition

It will soon be one year since COVID-19 pandemic hit the world. It has impacted almost all aspects of life, more so the economy. We are experiencing paradigm changes in the economic, social and psychological aspects of humanity. With the more and more involvement of technology, the manners in which business is conducted and people function and transact are undergoing significant changes. Revival of economy is the biggest challenge the governments across the world are facing. Governments are, broadly speaking, taking two pronged actions. On the one hand, various incentives are being provided either through cash or kind, while on the other hand the rigours of regulatory requirements are being relaxed by postponing or modifying the relevant rules. It is heartening to see the international cooperation in dealing with the pandemic. International organisations like Organisation of Economic Cooperation and Development (OECD) and the United Nations (UN) are examining the pain points of taxpayers and assisting tax authorities in minimising those. India, like many countries has been proactive in addressing the economic challenges, in general, and tax difficulties faced by stakeholders, in particular. The government has taken several steps for the latter, such as extending various time limits for tax compliances and tax payments, suspending debt recovery, quicker refunds to taxpayers, temporary changes in audit policy and introducing ways to provide quicker tax certainty, enhancing taxpayer services and communication.

Considering the difficulties caused by lockdown and suspension of international flights, the Government has provided temporary relief to the individuals who have not been able to move out of India in determining their residential status. Employees working from home in a jurisdiction which is different from that in which they habitually work is expected to create a risk of permanent establishment. Recent amendment in the FDI policy taken to prevent the opportunistic investors to takeover of Indian companies is yet another welcome move.

Due to exceptional circumstances created by COVID-19 pandemic the growth in Indian GDP has severely impacted. For sure, make in India initiatives have the potential to turn the Indian economy upwards. The Chartered Accountants fraternity, too, is geared up to take up the challenges being faced by the industry to revive the economy.

To keep our members abreast of the changes happening in the area of

International taxation, the Committee on International taxation of ICAI has taken efforts to revise its existing publication "Aspects of International Taxation". Considering its true nature, the publication has been renamed this year as "Basics of International Taxation".

I would like to appreciate the efforts of CA. Nandkishore Chidamber Hegde, Chairman, CA. G. Sekar, Vice-Chairman, and all members of the Committee on International Taxation of ICAI for the initiative taken to revise the said publication.

I am sure that this publication would be of immense use for our members practising in the area of international Taxation.

Best Wishes,

Place: New Delhi

Date : 21.10.2020

CA. Atul Kumar Gupta

President, ICAI

Preface to the Fourth Edition

The recent amendments by the Finance Act, 2020 witnessed that Indian tax system is getting ready to address taxation of digital business. On the one hand, the scope of Equalisation Levy has been widened. At the same time, the expansion of scope of deeming fiction to cover the advertisement income, income from sale of data, income from sale of goods or services; from a person who resides in India or from a person who uses Internet protocol address located in India are some notable changes in the Income-tax Act. Further, widening of income attribution concepts are a sign of migration from Function, Assets, Risks (FAR) approach to Function, Assets, Risks and Marketing (FARM) approach. The analysis of interplay between domestic law and tax treaties are going to be very challenging.

On the other hand the withdrawal of dividend distribution tax, rationalization of income tax rates, relieving non-resident taxpayers from income-tax return filing if income is only from royalty or fees for technical services earned from India and extension of sunset clauses for concessional rate of tax on certain specified income are welcome steps for ease of doing business in India.

Presently, the deadly consequences of novel COVID-19 have left no corner of the global economy unaffected. Even though all efforts are being made by the Government to revive the economy, there is still a long way to go. ICAI, as a professional body, is striving hard to contribute to the cause of the nation through all possible means.

One of the efforts in this regard, is up-dation of publications on the subject of International Taxation for dissemination of knowledge to its members. The Committee on International taxation of ICAI decided to make available the fourth revised edition of the publication to the members of ICAI. The first edition of the publication was prepared in the year 2006. There after there have been regular up-dations. The publication is very useful for anyone who wants to understand the basics of International Taxation. To reflect the true nature of the contents of the publication the Committee, has in this year decided to rename it as "*Basics of International Taxation*".

I am sincerely thankful to CA. Atul Kumar Gupta, President, ICAI and CA. Nihar Niranjan Jambusaria, Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

I whole heartedly acknowledge the contribution of CA. Sanjiv Chaudhary, past CCM, who has thoroughly revised the publication. He was actively assisted by CA Richa Sawhney, CA Vedika Kedia, CA Kashif Ali, CA Jiger Saiya, CA Dharmesh Bhambha, CA Keval Dharod, Niladri Bhattacharyya, CA Pragya Garg, CA Akansha Gupta and CA Himanshu Pal. I thank each one of them for their selfless and dedicated contribution for the cause of the profession. I am also thankful to CA. T. P. Ostwal, CA. Dhinal Shah, past CCM and CA. Karan Sukharami who spared their valuable time in reviewing the revised publication. Without their efforts this publication could not have been released in a timely manner.

I also whole heartedly acknowledge the efforts undertaken by Mr. S.P. Singh, Ex-IRS in overall reviewing this publication in a timely manner. Notably, Mr. S.P. Singh had been a part of the team that conceptualized Transfer Pricing law was introduced in India. His involvement has ensured that all views are dully taken care of. I am also thankful to CA. Ankit Arora who actively assisted Mr. S.P.Singh in this task.

I am also grateful for the unstinted support provided by Vice-Chairman CA. G. Sekar and also other Committee Council members CA. Tarun Jamnadas Ghia, CA. Chandrashekhar Vasant Chitale, CA. Dayaniwas Sharma, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Anuj Goyal, CA. Kemisha Soni, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, CA. Pramod Jain, CA. (Dr.) Sanjeev Kumar Singhal, CA. Charanjot Singh Nanda, Shri Manoj Pandey, Shri Chandra Wadhwa, Dr. Ravi Gupta; Co-opted members: CA. Sachin Sastakar, CA. Ujwal Nagnath Landge, CA. B.M.Agrawal, CA. Nidhi Goyal and Special Invitees: CA. Kriti Chawla and CA. Amar deep Singhal .

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation for co-ordinating the project and for rendering secretarial assistance and ensuring timely completion of the publication.

I am hopeful that this revised edition of this publication will be of immense use to the members.

Place: New Delhi
Date: 16.10.2020

CA. N. C. Hegde
Chairman,
Committee on International Taxation, ICAI

Foreword to the Third Edition

“Taxation” is highly complex and intriguing subject. The complexities and dynamic nature of taxation pose a number of challenges to all stakeholders – general public, business organisations, taxpayer and the tax consultant. Every stakeholder has his share of issues that needs a solution. Unfortunately there is no panacea to resolve the issues overnight. All concerned need to continually learn and relearn with the emerging changes in the subject.

In recent times area of International taxation has gained in importance. ICAI is all geared up to strengthen its members with the required learning in the area of International Taxation. Various activities are being undertaken by the Committee on International taxation to ensure that our members do not miss the plethora of opportunities available in respect of International taxation.

I am happy to note that yet another effort has been made by the Committee for updating the members by revising the publication “Aspects of International Taxation – A Study”

I appreciate the initiative taken by CA. Nihar Niranjan Jambusaria, Chairman, Committee on International taxation. I also compliment CA. Sanjiv K. Chaudhary, Vice-Chairman and other members of the Committee for their contribution in shaping up the contents and revising the publication.

I am sure that the revised edition of the publication will be immensely useful to the members in discharging their responsibilities in an effective manner.

Place : Hyderabad
Date : 19-10-2016

CA. M. Devaraja Reddy,
President

Preface to the Third Edition

International Taxation due to its dynamic and ever changing nature has always been a complex subject not only to study but to practice. Due to increase in cross border transactions, mergers and acquisitions, e-commerce, capital mobility and so on, the taxation laws have become more and more complex. This ever increasing complexity in taxation laws of the global village has been a matter of consultations, dialogues, debate, discussions at various forums. The resultant of the same is identification of the concept of Base Erosion and profit shifting (BEPS) and the action points to resolve the issues.

Every practising chartered accountant understands that International Taxation is an upcoming area of practice owing to global developments in respect of BEPS action plans. Since our professionals are competent and well prepared to take up the challenges involved in working in the borderless world, ICAI too is geared up to support them in respect of the required knowledge up-dation. To help our members to build the capacities in the area of international taxation, apart from other initiatives the ICAI through dedicated Committee on International Taxation Committee has been revised the publication "Aspects of International Taxation- A Study". This publication broadly covers all aspects of International Taxation including taxation of non-residents, DTAAs, Transfer Pricing, advance rulings, taxation of e-commerce, Foreign tax credit, BEPS etc. Like the earlier version, this revised version too would be of immense use to our members.

My sincere thanks to CA. M. Devaraja Reddy, President and CA. Nilesh Vikamsey, Vice-President of the Institute of Chartered Accountants of India who have been the guiding force behind the revision of this publication.

I have no words to effectively appreciate the untiring efforts of CA. Sanjiv Chaudhary who had not even piloted the first edition but also extended his support in revising this third edition. I also express my gratitude to him for his support as a Vice-Chairman of the Committee on International Taxation.

CA. Mayur Desai, CA. Parul Mehta, CA. Karishma Phatarphekar, CA. Anuradha Rathod, CA. Mrugen Trivedi, CA. Madhavi Mandovra, CA. Mugdha Desai, CA. Hetal Mehta, CA. Shailendra Dhole, CA. Vidhya Ganapathiraman, CA. Nidhi Khanna, CA. Ajay Agrawal, CA. Vinaya Phanse, CA. Alpesh Shete, CA. Ashish Choudhari, CA. Karnik Kansara and CA. Bhavesh Hodar have provided their dedicated and active support to CA. Sanjiv Chaudhary in

revising this publication. I whole heartedly appreciate the contribution made by each of them towards the profession.

I am also thankful to the other Committee Council members CA. Tarun Jamnadas Ghia, CA. Hegde Nandkishore, CA. Dhinal Ashvinbhai Shah, CA. Madhukar Narayan Hiregange, CA. G. Sekar, CA. Goyal Sushil Kumar, CA. Agrawal Manu, CA. SoniKemisha, CA. Sanjay Agarwal, CA. Atul Kumar Gupta, Shri Sunil Kanoria, Ms. Indu Malhotra and Co-opted members CA. Arpan Kiran Mehta, CA. T G Suresh, Ms. Parul Jolly, CA. P V S S Prasad and CA.M V Purushottama Rao who have contributed by giving valuable inputs in revising this Guidance Note.

I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary Committee on International Taxation and her team CA. Mohd. Waseem Qureshi for co-ordinating this project. I am sure that this edition like the earlier one will be useful to the members.

Place : New Delhi
Date : 2016

CA. Nihar N. Jambusaria
Chairman
Committee on International taxation of ICAI

Foreword to the Second Edition

International Taxation is evolving in response to globalization, capital mobility and the increased trade in services. The progressive development that has taken place in recent years have allured the multi-national corporations to enter into all types of business and trade formats in India and be at its own or engaging through domestic partners and channels. This introduces international tax practitioners, students and researchers to the theory, practice and international examples of the changing landscapes.

This has brought the Indian tax system to the attention of Multi-national Corporation on one hand and their professional consultants on the other hand requiring them to gain better understanding and familiarity of the Double Tax Avoidance Agreements (DTAAs) which play key role in the international taxation arena.

I am delighted to know that the Committee on International Taxation of ICAI has done a splendid work and have come out with the revised second edition of "Aspects of International Taxation- A Study".

I express my gratitude and appreciation to CA. Mahesh P. Sarda, Chairman, Committee on International Taxation of ICAI for the initiative taken to revise the publication. I thank CA. Sanjiv Chaudhary for his contribution in giving a concrete shape to this publication.

I am sure this book will be immensely useful and benefit all its readers by providing an insight into the complex aspects of International taxation with due clarity on the subject matter and in a simplified manner.

Place : New Delhi
Date : 06.01.2012

CA. G. Ramaswamy
President

Preface to the Second Edition

The globalization of the Indian economy has resulted in manifold increase in volume of international transactions. Apart from the quantum increase, the international transactions have become very complex. Consequently, tax implications of international transactions have assumed greater significance. The international tax is no longer restricted to corporates or to large cities. It is therefore imperative for the ICAI to empower the Membership in general on aspects of international tax.

The first edition of the 'Aspects of International Taxation' was brought out in 2002. The law both enacted law as well as judge made law had undergone substantial changes. Therefore, urgent need to update the publication was widely felt.

I am happy to state that CA. Sanjiv Chaudhary who piloted the project of the first edition readily accepted our request to revise the edition. The revised edition would not have seen light of the day without his untiring efforts. I do not think his efforts can be effectively appreciated through the medium of words.

CA. Sanjiv Chaudhary has been actively supported by CA. Sunil Lala, CA. Manoj Pardasani, CA. Mrugen Trivedi, CA. Naveen Kumar Gupta, CA. Maulik Mehta, CA. (Ms.) Manjusha Todankar and CA. (Ms.) Natasha Buhariwala. I place on record our sincere appreciation of the contribution made by each of them.

I thank CA. (Prof.) Tarun Chaturvedi for carrying out the vetting process.

I thank members of the Committee for immense support provided by them.

I believe the efforts in bringing out this publication will get amply rewarded if it proves to be useful to members of the Institute. It will be our endeavor to revise the edition more frequently. The publication contains discussion of case laws up to March, 2011. Considering flow of judicial pronouncements, we propose to come out with supplementary periodically.

I appreciate the efforts made by Mr. Ashish Bhansali, Secretary of the Committee on International Taxation for co-ordination and his team members CA. Govind Krishna Agarwal and Mr. Prakash for the secretarial assistance in bringing out the publication.

Place : New Delhi
Date : 06.01.2012

CA. Mahesh P. Sarda
Chairman
Committee on International Taxation

Foreword to the First Edition

The process of globalisation of the Indian economy initiated in the nineties has acquired momentum and the economy is growing at a rapid rate. India has become the hub of manufacturing, servicing and outsourcing activities for the multinational corporations. There has been an enormous increase in the inflow of funds from international financial institutions. India has taken great strides in information technology.

All the above developments have a great impact on taxation of the transactions arising out of such activities. Thus, international taxation is gradually becoming a major area of professional interest. However, the concepts and issues concerning international taxation are of a complex nature.

Realising the importance of the subject, the Fiscal Laws Committee has taken the initiative to come out with a detailed study of the issues connected with international taxation. I congratulate the Fiscal Laws Committee and its Chairman, Mr. Ved Jain for bringing this study.

I am sure that this study will be very useful for our members.

Place : New Delhi
Date : 02.02.2006

K. S. Vikamsey
President

Preface to the First Edition

The advent of economic reforms in our country has resulted in the rapid growth of the Indian economy. The process of globalisation is set to gain further impetus with the good performance of the economy in the last two years. There has been tremendous increase in the activities of multinational corporations and other non-residents in the manufacturing and servicing sectors of the economy. Outsourcing, which was confined only to non-core activities has been expanding its scope to cover even core and strategic activities of the foreign corporates. The inflow of funds from international financial institutions has been extremely impressive. India has emerged as a major player in the arena of information technology.

These developments in the frontiers of business has naturally resulted in the emergence of taxation issues which have cross-border implications. The Indian Income-tax law has been responding to the developments in this regard. Double Taxation Avoidance Agreements and Transfer Pricing Regulations are some of the examples in this regard. The Authority for Advance Rulings has also made significant pronouncements on various issues of international taxation.

The Fiscal Laws Committee decided to come out with a study covering all the relevant issues relating to international taxation. Accordingly, Shri Sanjiv Chaudhary, FCA, New Delhi was asked to prepare the basic draft. I am extremely thankful to him for his valuable contributions. I also thank the members of the Fiscal Laws Committee for their valuable suggestions in bringing out this study. I am particularly thankful to Shri K. S. Vikamsey, President and Shri T. N. Manoharan, Vice-President who have been the guiding force behind this publication.

I also thank Shri R. Devarajan, Secretary, Fiscal Laws Committee and Ms. Mukta Kathuria, Executive Officer for coordinating this project and Shri Y. S. Rawat, Sr. Steno-Typist who rendered the secretarial assistance.

I am sure that this study will help the members in understanding the issues involved in international taxation in a methodical manner.

Place : New Delhi
Date : 02.02.2006

Ved Jain
Chairman
Fiscal Laws Committee

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ECONOMIC ANALYSIS OF INTERNATIONAL TAXATION

1.1 A Glimpse of International Trade

"The hardest thing in the world to understand is the income tax."- Albert Einstein

With all the nuances that the taxation system in the world is grappling with, the above quote from one of the greatest minds, is clearly standing the test of time in its widest sense.

Before proceeding with the subject on international tax, it will be useful to have a glimpse of the current international trade environment. Recently, on account of the Covid-19 pandemic, the international trade environment has been vastly effected and people evaluating newer ways of doing business.

Last decade has witnessed several radical changes in the world economy. The traditional brick and mortar business is giving way to the internet led e-commerce. Competition is changing from product enhancement model to innovative disruption model, the traditional boundaries of the countries are getting dimmer with the seamless opportunities provided by internet and e-marketplaces. In nutshell, the world is going through a sea of changes in the way the businesses are run.

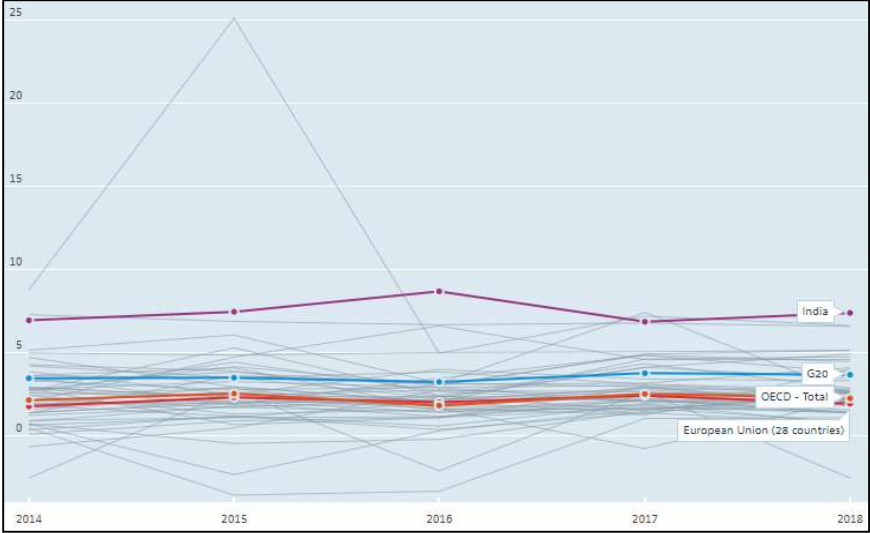
In the recent past there has been a significant rise in the exports and imports. The highest international trade has been seen in 2018 when compared from 2011 of all the G20 economies. The trends of international trade in G20 nations can be pictorially depicted as under:

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Source: oecdoobserver.org

The GDP¹ of many countries have gone from peak to trough and to peak again as part of natural business cycle. The yearly GDP movement from 2014 to 2018 can be seen as under:



Source: data.oecd.org

¹ Gross Domestic Product (GDP) is the standard measure of the value of final goods and services produced by a country during a period minus the value of imports

Economic Analysis of International Taxation

The kaleidoscope of International trade over the past decade has made it imperative for the States to inter-alia reassess their international and domestic tax policies. The Multinational organisations are now seeking innovative ways to structure their operations and maximize their post-tax returns.

The ability and willingness of taxpayers to create diverse and complex global value chains, shift taxable income between jurisdictions, and respond to incentives created by the interaction of domestic and foreign tax rules, necessitates mindful formulation of tax policies.

Global Tax rate trends:

At this stage, it may also be useful to see the trends in the tax rates over last decade. The changes are sometimes a result of medium to long term economic policy of a country, but at times, a nervous reaction to the state of businesses with intention to safeguard the revenue.

Tax rate differences over time and between countries can be very large, and are capable of significantly affecting the post-tax returns to FDI in a particular jurisdiction. The global trends in corporate tax levies for the previous decade shows a continuing decline in the rates. The same can be seen from the 'Table A' below. Due to the US Tax Reforms in 2017, corporate tax rates in North America have seen a sharp decline from 36.50% in 2009 to 26.75% in 2019. A similar trend of decline in tax rate has also been seen in Indian tax scenario where the corporate tax has been slashed to 25% plus surcharge and cess (for companies whose turnover or gross receipt does not exceed 400 crores in FY 2017-18) in 2019 from erstwhile 33.99% in 2009.

Further, on 20 September 2019, India announced a significant reduction of corporate tax rate. Indian companies can now opt for a 22% corporate tax rate plus surcharge and cess effective taxable years beginning 1 April 2019. Further, for the new manufacturing companies set up on or after the prescribed date, the reduced rate of 15% plus surcharge and cess has been provided. However, the companies opting for reduced tax rate will not be eligible for various incentives and deductions provided under the Act.

Basics of International Taxation

Table A: Corporate Tax Rates

Location	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Africa average	28.83	28.49	28.64	29.07	28.33	27.83	28.14	28.03	28.21	28.26	28.24
Americas average	28.82	28.28	29.31	28.67	28.35	27.77	27.61	27.71	28.29	27.97	27.21
Asia average	25.37	23.72	22.91	22.72	22.13	22.00	21.98	21.41	21.08	21.21	21.09
Europe average	21.64	21.46	20.83	20.44	20.60	20.42	20.05	19.97	19.53	19.48	19.35
Oceania average	29.20	29.00	28.60	28.60	27.00	27.00	27.00	27.00	28.43	28.43	28.43
North America average	36.50	35.50	34.00	33.00	33.00	33.25	33.25	33.25	33.25	26.75	26.75
Latin America average	27.96	27.52	28.88	28.30	27.96	27.31	27.16	27.29	27.98	28.05	27.24
EU average	23.11	22.93	22.70	22.51	22.75	22.39	22.15	22.09	21.33	21.29	21.12
OECD average	25.64	25.70	25.42	25.18	25.32	24.98	24.77	24.69	23.95	23.53	23.35
BRICS Average	29.51	29.51	29.20	29.20	28.20	28.20	28.32	28.32	28.32	28.40	27.40
Global average	25.32	24.65	24.52	24.38	24.17	23.88	23.77	23.62	24.06	24.02	23.79

The global trends in individual tax rates can be seen in the below Table B. Globally the average tax rates have risen with the exception of Europe and Oceania regions where highest decline is seen. Highest rise in the average tax rate can be seen in Africa from 26 % in 2009 to 31.96% in 2019. In India the average tax rate has risen from 30% in 2009 to 35.88% in 2019. Further, vide Finance Act, 2020, a new optional tax regime has been introduced for individuals with modified tax slabs and rates (tax rate ranging from 5% for income upto 5 lakhs to 30% for income above 15 lakhs) without considering prescribed exemptions / deductions such as leave travel concessions, house rent allowance, standard deduction, professional tax, donations etc.

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Table B: Personal Tax rates

Location	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Africa average	26.00	26.16	26.00	27.62	31.41	31.41	31.63	31.60	31.92	32.40	31.96
Americas average	31.30	31.86	31.23	31.67	31.48	31.43	31.59	31.68	32.59	32.82	32.56
Asia average	27.96	27.96	27.52	27.96	26.82	27.20	27.09	27.35	27.65	27.67	27.99
Europe average	34.40	34.90	34.67	34.95	32.62	33.05	32.12	32.37	32.67	32.18	31.87
Oceania average	39.00	38.38	37.75	37.75	33.40	33.40	33.40	33.40	33.40	33.40	33.40
North America average	32.00	32.00	32.00	32.00	34.30	34.30	34.30	36.30	36.30	35.00	35.00
Latin America average	31.22	31.84	31.14	31.64	31.25	31.20	31.37	31.31	32.31	32.67	32.40
EU average	37.03	37.30	37.09	37.47	38.37	38.38	37.37	37.84	38.30	38.24	38.27
OECD average	40.26	40.76	40.40	40.89	41.78	41.78	41.10	41.74	42.15	42.01	41.65
BRICS Average	31.10	31.10	31.10	31.10	31.90	31.90	31.90	32.41	33.21	33.28	33.28
Global average	31.23	31.52	31.10	31.59	30.86	31.08	30.80	30.97	31.41	31.39	31.23

Various jurisdictions have attempted to incentivize investment through favorable rates, domestic investment policies, favorable Treaty clauses, speedy and simpler dispute resolution mechanisms, tax credit mechanisms etc.

Weaknesses in the existing international taxation rules had created opportunities for profit shifting, requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created. To counter the problems emanating from the new global environment, the G20 leaders and the OECD proposed to counter Base Erosion and Profit Shifting (BEPS) in September 2013. After two years of relentless efforts the OECD with contributions of G20 and other organisations², the OECD delivered a package of 15 Action

² organisations such as the African Tax Administration Forum (ATAF), *Centre de rencontre des administrations fiscales* (CREDAF) and the *Centro Interamericano de*

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points putting in place commonly-agreed international tax standards aimed to better align the location of taxable profits with the location of economic activities and value creation, and improve the information available to tax authorities to apply their tax laws effectively.

These 15 Action Points were built around three pillars viz. coherence, substance and transparency, as under:

Coherence: New international standards must be designed to ensure the coherence of corporate income taxation at the international level.

Substance: A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological development.

Transparency: The actions implemented to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business.

The final reports of 15 Action Plans contained recommendations that fall into different categories as below ranging from minimum standards, reinforced international standards and common approaches.

Particular	BEPS Action
Minimum Standards	Action 5- Harmful tax practice
	Action 6- Treaty Abuse
	Action 13- Country by Country reporting
	Action 14- Dispute resolution
Common approaches & best practices for domestic law	Action 2- Hybrid Mismatches
	Action 3- Controlled Foreign Company (CFC)
	Action 4- Interest Limitations
Reinforced International Standards	Action 7- Permanent Establishment (PE)
	Action 8-10- Transfer Pricing

Administraciones Tributarias (CIAT) joined international organisations like the International Monetary Fund (IMF), the World Bank (WB) and the United Nations (UN) contributed to the work

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Particular	BEPS Action
Others reports	Action 1- Digital Economy
	Action 15- Multilateral Instrument (MLI)

“Minimum standards” are those wherein countries have agreed to adhere to and implement on negotiable basis. Each country is expected to abide by the same. “Reinforced standards” are those which are invariably found in existing tax treaties or domestic laws of countries, but which are supplemented and ‘toned up’ under BEPS agenda. “Best practices” are optional but the expectation is that the countries will cooperate by adopting such practices within recommended framework in a manner that countries work towards common goal within reasonable time frame. Further, with respect to Action Plan 1 and 15, substantial work has been done.

To appreciate the current global environment and conduct business in a tax efficient manner, it is important to understand the key aspects of international tax which are enshrined in the following chapters of this book and the subtle nuances discussed therein.

1.2 Avoidance of double taxation - history and economic justification

The following contents of this book will introduce you to some of the key aspects of international taxation in the backdrop of the domestic regime prevailing in India. To begin with it would be interesting to look at the brief history of how double taxation was sought to be avoided.

International Law has evolved out of needs of trade (like shipping) which necessitated certain accepted codes of conduct being recognized even in domestic law though the transaction may be between the two different countries. It is really in the field of tax agreements that the first major steps for an international society were taken.

Double taxation occurs when two or more jurisdiction seeks to tax the income arising out of the same transaction. It is more than essential that such double taxation be eliminated for smooth conduct of international trade.

The genesis of Double Taxation Avoidance Agreements (DTAAs) can be traced back to the process initiated by the League of Nations in its attempts to form an international community. It prepared a first formal draft of a Treaty in 1927. After World War II, Conventions in Mexico and London in 1943 and 1946, respectively, proposed variations. This work was taken over by the

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predecessor of the OECD which came out with a draft in 1963, which is called the Model Convention. It was following the publication of this draft that rapid developments took place in emergence of an international treaty network. This resulted in the publication in 1977 of a new Model Convention and Commentaries, by which time there was already a well-advanced treaty network among the members. A need was felt to update and adapt the Model Convention of 1977 considering the fundamental changes taking place in the ways in which cross-border transactions were being undertaken. This led to publication of the 1992 Model Convention in a loose-leaf format. Unlike the 1963 Draft Convention and the 1977 Model Convention, the revised Model was not the culmination of a comprehensive revision, but rather the first step of an ongoing revision process intended to produce periodic updates and thereby ensure that the Model Convention continues to reflect accurately the views of Member countries at a given point in time. In the later updates, published in 1997, the positions of non-Member countries on the Model Convention were also added. The OECD now periodically updates the Model Commentary. It has also published separate publications e.g. "Attribution of profits to Permanent Establishment (PE)", "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Existing TPG)".

1.3 What is a treaty?

'Treaty' as understood by a layman is "a formally concluded and ratified agreement between independent nations".

Tax treaties [also known as Double Taxation Avoidance Agreements (DTAAs)] are generally a result of bargaining taking into consideration the economic interests of the countries involved. Some concessions may be made keeping in mind political and trade considerations. DTAAs play an important role in encouraging inflow of investments into the country by providing certainty of taxation. A businessman would like to know the returns after tax on his investments. DTAAs enable a taxpayer to estimate his liabilities and duties towards compliance with the foreign countries' tax laws. Keeping all interest in mind, a country may have to give up the right to tax one source of income but may want to justify taxing another source of income, which arises in its territory, for example, a country with a busy port would push for exemption of shipping income for its residents and agree to give concessions to the partner country which would be in the interest of its residents

DTAAs are used by countries to serve the dual purpose of encouraging its own residents to compete in the world markets and encourage inflow of capital while at the same time help countries curb tax evasion. This is the reason behind the Article for “Exchange of Information”. There has been a flight of capital to countries with lower rate of tax or tax havens. Under-invoicing of exports and over-invoicing of imports or setting- up dummy companies in tax havens; are some common means of tax evasion. The Article on “Exchange of Information”, if used effectively, would help in nabbing such tax evaders. Therefore, India recently has been focusing on renegotiating its Treaties to enable exchange of information to trace black money.

1.4 In India, how does a treaty become law?

The agreement entered into becomes a part of domestic law only when it has sanction of the constitution of the nations, which are a party to it. In India, Part IV of the Indian Constitution, setting out the “*Directive principles of State Policy*”, includes a specific provision covering international law and treaty obligations in Article 51 as follows:

“The State shall endeavor to –

- a) *promote international peace and security;*
- b) *maintain just and equitable relations between nations;*
- c) *foster respect for international law and treaty obligations in the dealings of organized people with one another; and*
- d) *encourage settlement of international disputes by arbitration.*

The judgment in *Shah J. Meganbhai v. UOI AIR 1969 SC 783* spells out the true nature of the power of the executive under the Constitution to make a treaty or to implement a treaty with a foreign State.

As it explains, the power of the Union of India is co-extensive with the legislature power of Parliament under Article 73. Accordingly,

- “(1) Subject to the provision of this Constitution the executive power of the Union shall extend;*
 - (a) to the matter with respect to which Parliament has powers to make laws; and*
 - (b) to the exercise of such rights, authority and jurisdiction as are exercisable by the Government of India by virtue of any treaty or agreement”.*

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The power to legislate is conferred on the Parliament by entries 10 and 14 of List I of VII Schedule. Therefore, the Central Government has power to enter into DTAA. However, all Treaties are also required to be followed by local legislation. As the Legislature in India has delegated the power to the Executive, a formal approval of a Treaty by notification or such other means of ratification is required.

1.5 Source rule v. Residence rule of taxation

Double taxation may happen in two ways; when the same income is taxed in two countries in the hands of a single taxpayer (jurisdictional double taxation) or taxation of the same income in the hands of two taxpayers (economic double taxation). The DTAA would, normally, decide on the distribution of the income between the two countries. Taxation of same income in more than one hand amounts to economic double taxation so that the revenue sharing between the countries gets distorted e.g. capital expenditure being disallowed while income is taxed in the hands of the recipient. Generally, in Treaties focus is more on relieving juridical double taxation.

Most countries adopt residential status as the basis of taxation but at times the source or territoriality principle is also adopted so as to tax the income in the country where it arises. Typically, double taxation arises when there is overlapping of jurisdiction to tax in two countries.

The UN Model has a slant on source principle and it is generally believed that it is more lenient to developing countries than the OECD Model. The UN Model also tries to ensure removal of discrimination between taxpayers in the international field. However, the common objective of the Governments while negotiating treaties is to ensure that tax revenues are shared in a manner most optimal to both. The common objectives of Treaties, irrespective of which Model is used as a base, would be to remove the burden of double taxation which harms free movement of goods, capital, services, technology and persons between Countries.

DTAAs of India are generally a mix of both source taxation and residence taxation. The main negotiation takes place in assigning the right to tax the income between the countries. A country would like to keep with it the right to tax its resident on his global income whereas; the country of source would also like to stake a claim to the pie. Therefore, a settlement is reached under the treaty, say allowing the country of source to take a percentage of the income e.g. in case of royalty and FTS. In certain cases, the right to tax is left with the country of residence unless there is substantive activity in the

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source State e.g. business profits are only taxed, as said above, if the business is carried on through a PE. In India, the domestic law also emphasizes that income of a non-resident will be deemed to accrue or arise in India whether or not the non-resident has a residence or place of business or business connection in India or the non-resident has rendered services in India.

The International Fiscal Association in 38th Congress in Buenos Aires has resolved that the source system of taxation is preferable. Therefore, most DTAA's have a combination of both source as well as residence form of taxation.

The source rule is also sometimes referred to as the "classification or assignment rule" as it classifies the income with reference to the source. The country where the income is generated gets the right to tax it. The logic behind it is that it is that country which has, so to say, nurtured the income e.g. in case of royalties and patents, may have allowed tax breaks in the development of the patents and would now want a share in the revenue earned from those royalties or patents.

Therefore, while negotiating DTAA's, countries try to bargain hard in their best interests and often a compromise is reached depending on each country's strengths and its bargaining power. This compromise may be reached in the form of a lower rate of tax at which the source country is allowed to tax the income e.g. royalty, FTS. This leads to another issue, i.e., whether the income should be taxed on gross basis or net basis. A balance in the scheme/right of taxation between the countries is sought to be achieved so as to make it an easy and level playing field for all. This is a challenge as the way of doing business has changed, from the traditional to e-commerce. Therefore, establishing jurisdiction over income has become even more difficult.

The earlier guiding principle in determining the source of income and the location of the gross profit was to ask the question "what has been done to earn the profit?" Now the more appropriate question would be "what and where has the profit earning activity been carried out?"

In case of tangible goods profits arise when they are delivered. However, with the increased use of technology and e-commerce, it is necessary to adopt appropriate systems to determine point of taxation. This is to ensure that a country does not lose out on the right to tax an income e.g. an

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international book store or record company selling its books or records in India either through an exclusive agent or by setting up its brand shop in India would be taxed; however if the same company sells goods through the Internet, which are directly delivered through mail/courier it would become very difficult to capture such sales and further there would be no business connection/PE to bring that company to tax in India. Hence, a concept of 'Significant Economic Presence' was suggested by BEPS Action Plan 1 to tax such transactions. India introduced the concept of 'Significant Economic Presence' in its domestic law by Finance Act, 2018. However, the applicability of the same has been deferred to Financial Year 2021-22. (In the subsequent chapter dealing with taxation of e-commerce the complexities involved in establishing the State of Source will become clearer.)

The digital economy and its business models present some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multisided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services etc. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations. Recently OECD has vide Action point 1 of its BEPS initiative has tried to identify and tackle some key challenges posed by digital economy. The same is broadly discussed subsequently in this book in a separate chapter on BEPS.

2

BROAD FEATURES OF THE INCOME TAX ACT, 1961

2.1 Charge of tax and persons

Income tax simply put, is a tax on income, of a person, for a defined period. The power to levy tax is of wide import and rests with the Parliament. In terms of the power given under the Constitution, the Parliament has enacted the Income-tax Act, 1961 ('the Act'), and various other statutory Acts. The word "income" though is not defined in the Constitution. However, the same is defined in Section 2(24) of the Act.

The definition of income is an inclusive definition. It includes not only those things which this clause declares that it shall include, but such things as the word signifies according to its natural import [*Raghuvanshi v. CIT (1952) (22 ITR 484) (SC)*]. Therefore, if a particular receipt, though not specifically included as income, is in the nature of income, it is liable to be taxed. The Supreme Court in the case of *G.R. Karthikeyan [(1993) 201 ITR 866]* observed that "The idea behind providing an inclusive definition in section 2(24) is not to limit its meaning but to widen its net. This court has repeatedly said that the word 'income' is of the widest amplitude and it must be given its natural and grammatical meaning". Further, in the case of *Emil Webber v. CIT [(1993) 200 ITR 483]*, the Supreme Court analyzed that it is difficult to define the expression 'income' in precise terms. Anything which can properly be described as 'income' is taxable under the Act unless, it is exempted under one or the other provision of the Act.

The tax is levied on the "income" for the year. In determining the income, the income received as well as the income accrued has to be considered. The method of payment or its measure is not important. Income includes not only money payment but also the value of any benefit or perquisite, whether convertible into money or not [*K. C. Suresh v. Director of Lotteries (1993) (199 ITR 266) (Ker HC)*]. Any kind of income earned by the assessee attracts income-tax at the point of earning, and tax law may not be concerned with how the income is expended. Some of the basic concepts around taxation of income are explained below.

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Distinction between revenue receipt and capital receipt

“Income” as generally understood, means receipt of a revenue nature. However, in the case of certain receipts e.g. surrender of agency rights, the taxpayer would treat it as a receipt on capital account whereas the tax authorities would want to tax it as a revenue receipt. These classification issues for certain types of income i.e. on revenue or capital account has led to disputes between the taxpayer and the tax authorities. Fundamentally, only revenue receipts and not capital receipts are taxable except to the extent of any capital receipt being expressly covered under the definition of ‘income’. What should constitute revenue and capital is to be decided on the facts of each case.

The Supreme Court in the case of *Oberoji Hotel (P) Ltd. v. CIT* [(1999) XI SITC 109 (SC)], has held that the question whether the receipt is in the nature of capital or revenue has to be determined by drawing the conclusion of law ultimately from the facts of the particular case and it is not possible to lay down any single test as infallible or any single criterion as decisive. The Bombay High Court in *CIT v. Mahindra And Mahindra Ltd.* [(1973) 91 ITR 130] has observed that a receipt is not taxable if it is referable to fixed capital. It is taxable as a revenue item when it is referable to circulating capital or stock-in-trade. The fixed capital is what the owner turns to profit by keeping it in his own possession. Circulating capital is what he makes the profit of by parting with it and letting it change its masters. The determining factors must be the nature of the trade in which the asset is employed.

Real income theory

Income-tax is a tax on the real income. It is the real income which has accrued in a practical sense that is brought into account for tax purposes [*CIT v. Bokaro Steel* [(1999) (236 ITR 315) (SC)], *Godhra Electricity Co. Ltd. v. CIT* [(1997) (225 ITR 746) (SC)]. The Bombay High Court in the case of *CWT v. Bombay Suburban Electric Supply Limited* [(1976) 103 ITR 384] held that “..Income tax is a tax on the real income i.e., profits arrived at on commercial principles subject to the provisions of the Act”. A similar view was also taken in *Poona Electric Supply Co. Ltd v. CIT* [(1965) (57 ITR 521) (SC)]. A noteworthy decision in this respect is the decision of the Supreme Court in the case of *State Bank of Travancore v CIT* [(1986) (158 ITR 102) (SC)] wherein it was held that if income which may have accrued in theory, but has been surrendered in reality, it cannot be said that any

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income has resulted; because the income did not really accrue. Whether income has really accrued or not has to be decided in the light of the facts of each case so as to uphold the intention of the Act. It may be worthwhile to note here that in the context of recognition of interest on non-performing assets, the Courts have held that even under the accrual system of accounting, it is illusory to take credit for interest where the principal itself is doubtful of recovery. The Courts, in various decisions, have also recognized the theory of "real income" and held that notwithstanding that a taxpayer may be following the mercantile system of accounting, the taxpayer could only be taxed on real income and not any hypothetical/illusory income. [*UCO Bank v. CIT* [1999] 237 ITR 889 2 (SC), *CIT v. Shoorji Vallabhdas & Co.* [1962] 46 ITR 144 (SC), *Godhra Electricity Co. Ltd. v. CIT* [1997] 225 ITR 746 1 (SC), *CIT v. Bokaro Steel Ltd.* [1999] 102 Taxman 94/ 236 ITR 315 (SC)].

It is important to note that the Legislature includes deeming fictions within the Act when it intends to tax hypothetical income (such as section 56(2)(x) which taxes the notional income in the hands of the recipient.

Presumptive taxation

Existing along with the concept of real income is the concept of presumptive taxation. In certain cases, especially in the case of non-residents where it is not possible or would be cumbersome, the legislature prescribes a presumptive rate on receipts for determining income chargeable to tax e.g. In case of Shipping Income, seven and a half percent of shipping receipts is deemed to be the income arising from shipping business on which the tax is levied at the applicable rate; in case of non-residents engaged in oil exploration activities an amount equal to ten percent of receipts is deemed to be the income on which tax is levied at the applicable rate. The important point is that the presumptive rate is applied on the receipts and not on the income. This leads to the question, whether a deduction can be allowed for the expenses incurred in the business? It is an accepted view that, where a presumptive rate is applied, all expenses have been deemed to be allowed, and nothing further is allowable. Therefore, it is the gross receipts on which tax is levied.

In certain situations, in case of residents also, presumptive taxation may apply e.g. in case of residents engaged in any business (except business of plying, hiring or leasing goods carriage) whose total turnover in the previous year does not exceed specified amount, a sum equal to eight percent of the total

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turnover or gross receipts paid or payable is deemed to be the income from the business. In order to promote digital transactions and to encourage small unorganized business to accept digital payments, the rate of taxation was reduced to six percent for amount of turnover (or gross receipts) received by an account payee cheque or account payee bank draft or through use of electronic clearing system through a bank account.

Income-tax is a tax on income, which is levied with reference to a person for a specified period. This is done by dividing the taxpayers into various categories of persons. It is a tax on income of a person for a particular assessment year levied at the rates specified in the Finance Act.

'Person' – The charge of tax is on a 'person' which is defined under section 2(31) of the Act. According to section 2(31) 'person' includes the following:

- (i) an individual,
- (ii) a Hindu undivided family,
- (iii) a company,
- (iv) a firm,
- (v) an association of persons or a body of individuals, whether incorporated or not,
- (vi) a local authority, and
- (vii) every artificial juridical person, not falling within any of the preceding sub-clauses.

The definition of 'person' is an inclusive definition and covers almost all categories of taxpayers. However, though their natural meanings may be the same, the term 'individual' and 'persons' are different under the Act. While every 'individual' is a 'person' every 'person' is not an individual'. The term 'individual' refers to a natural person i.e. human being while the term 'person' also includes artificial juridical persons like idols and deities. For appreciating the legal nature of the various categories of "person" included in the definition the relevant law may be referred to, wherever required.

'Hindu undivided family' is a concept which is unique to Indian tax laws. This status arises from being a family, as the title suggests, and which incorporates all new members born into the family.

The term 'company' in the definition of "person" covers all companies within its ambit whether incorporated inside India or outside India. The term

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'company' used in this section is to be read in conjunction with the definition of 'company' in section 2(17) of the Act.

The term 'partnership' as included in section 2(23) of the Act takes us back to the definition of 'firm', 'partner' and 'partnership' in the Indian Partnership Act, 1932. With the concept of limited liability partnerships being introduced, the definition of 'firm' has been amended to include limited liability partnership as defined in the Limited Liability Partnership Act, 2008 and the definition of 'partner' has been amended to include a partner of a limited liability partnership as defined therein. In the Act a 'firm' is treated as a separate taxable entity that is distinct from its 'partners'. In fact, till the time the Finance Act, 1992 introduced section 10(2A) to the Act w. e. f. 1 April 1993, both the partner and the partnership were taxed. As this amounted to taxing the same income twice, once in the hands of the firm and then again in the hands of the partners, section 10(2A) of the Act was introduced which provides that the share of profit that a partner receives from a firm will be exempt in the hands of the partner. Therefore, though the Act still recognizes that the firm and the partners are independent, double taxation of the same income is avoided.

An 'association of persons' as the name suggests is a group of 'persons' who may or may not be individuals.' In fact, in the 1922 Act, the term used was 'association of individuals' which was changed to 'association of persons' to remove any doubt that the term included persons other than individuals also. The term 'body of individuals' is similar to 'association of persons' and denotes a group of persons joining together to earn income. The Finance Act, 2002, w.e.f. 1 April 2002, inserted an Explanation to clarify that an 'association of persons', 'body of individuals', 'local authority' or 'juridical person' will be deemed to be a 'person' irrespective of whether the 'association of persons', 'body of individuals', 'local authority' or 'juridical person' was formed with the object of deriving profit or not.

A 'local authority' is also a unit of assessment. The *Explanation* referred to above, inserted by the Finance Act, 2002, also applies to a local authority.

There is also a residuary clause to include any other category not specifically mentioned. In the 1922 Act, there was no separate category for idols or deities and they were included under individuals. Under the 1922 Act the presumption was that the word "individual" is wide enough to cover idols, statutory bodies like Bar Council, or a University. However, the 1961 Act has a separate category in

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clause (vii) viz. 'every artificial juridical person'. Person not falling within any of the preceding sub-clauses' fall within this category. The *Explanation* specifying that profit motive is not important is equally applicable to these entities.

In order to fasten tax liability on a person, two essential elements to be considered are: i) the scope of total income, and ii) the residential status of the person. The levy of tax is contemplated in section 4 of the Act, the scope of total income in section 5 of the Act and meaning of a 'resident' in section 6 of the Act.

Rate - 'rate or rates in force' is defined in section 2(37A) of the Act and takes one back to the rate specified in the Finance Act of the relevant financial year. The charging section 4(1) of the Act also stipulates that the tax shall be charged on the income computed as per the provisions of the Act at the rate specified in the Central Act. However, it is important to note the following words in section 4 "*those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of this Act....*". This is because, in respect of certain incomes, the rate of tax is already specified in the Act and is not varied by the Finance Acts. The Supreme Court in the case of *CIT v. Vatika Township (P.) Ltd. [(2014) (49 taxmann.com 249)]* observed that Chapter XIVB comprehensively takes care of all the aspects relating to the block assessment and undisclosed income, which includes section 158BA(2) as the charging section and even the rate at which such income is to be taxed is mentioned in section 113. It observed that "*.....when a separate charging section is introduced specifically, to assess the undisclosed income, notwithstanding a provision in the nature of section 4 already on the statute book, this move of the legislature has to be assigned some reason, otherwise, there was no necessity to make a provision in the form of section 158BA(2). It could only be that for assessing undisclosed income, charging provision is section 158BA(2) alone....*"

Where the rate is not so specified, the rates stated in the Finance Act will apply. The Finance Act prescribes the rate of income tax for the year, the rates for deduction of tax at source and the rates for payment of advance tax. The income tax is an annual tax, not only in the sense that it is annually imposed by the Finance Act but in the sense that it is annual in its structure and organisation. Though the subject of the charge is the income of the previous year, the law to be applied is that in force in the assessment year, unless otherwise stated or implied [*Reliance v. CIT (120 ITR 921) (SC)*].

The power and the authority to levy the income-tax are granted by the Constitution of India. Any provision introduced in the Act and the rates

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specified will be constitutionally valid unless otherwise held by the Courts i.e. the High Court or the Supreme Court. The burden of showing that a receipt does not constitute income taxable under the Act is upon the taxpayer. The Act is a self-contained exhaustive code subject to interpretation by the Courts.

Previous year – The income is to be computed with reference to a previous year. Previous year has been defined in section 3(1) of the Act to mean the financial year immediately preceding the assessment year. This takes us back to the definition of assessment year in section 2(9) of the Act which defines assessment year to mean the period of twelve months commencing on the 1st day of April every year. The only exception provided is in case where a business, profession or vocation is newly set up, or a source of income newly comes into existence, in the financial year, the 'previous year' would be the period from the date when the business, profession or vocation is set up or the source of income comes into existence to the March 31, next following.

The period to be considered under the Act is April-March and not the calendar year. The fiscal period may differ from country to country and when dealing with international tax matters it may create complications, especially if taxes paid have to be split into two different fiscal periods.

Eligibility to tax is determined by the scope of section 5 of the Act.

2.2 Scope of total income

The term 'total income' has been defined in section 2(45) of the Act to "*mean the total amount of income referred to in section 5, computed in the manner laid down in the Act*". The definition thus goes back to the scope provided in section 5. Therefore, while computing the total income, one has to have regard to the scope of income specified in section 5 of the Act and then compute the income in the manner laid down in the Act. Total income is the entire income of a 'person' received or deemed to be received or which accrues or is deemed to accrue in a previous year.

Section 5 defines the scope of total income. Section 5 classifies the total income based on residential status. Section 5(1) deals with 'residents' and section 5(2) deals with non-residents. Section 5 also starts with the phrase '*Subject to the provisions of this Act....*'. Therefore, if an income is exempt under section 10 (which exempts certain income from tax), it cannot be taxed simply because a charge is put by section 5.

Section 5 refers to income 'received' and 'accrued'. In the case of a resident, there are three situations contemplated namely, receipt and/or

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deemed receipt in India, accrual and/or deemed accrual in India and accrual outside India. The point to note here is that in the case of income accruing/arising outside India there are no deeming provisions, and therefore, the income needs to have actually accrued or arisen to be taxed.

In the case of a non-resident, there are two situations contemplated i.e. when income is received or is deemed to be received in India and when it accrues or is deemed to accrue or arise in India irrespective of actual receipt.

The receipt need not be by the resident or non-resident himself. Even if it is received by someone on his behalf, it is taxable. If a person has alienated or assigned the source of his income so that it is no longer his, he may not be taxed upon the income arising from the assignment of the source [*E.D. Sassoon v. CIT (26 ITR 27) (SC)*]. However, if he does not transfer the source of income and merely applies the income so that it passes through him and goes to an ultimate purpose, even though he may have entered into a legal obligation to apply it in that way, still it remains his income. The Supreme Court in the case of *CIT v. Sitaldas Tirathdas [(1961) (41 ITR 367)]* held that “.....where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow....” Thus, where income is not ‘applied’ but ‘diverted by overriding title’ from the assessee who would otherwise have received it, it cannot be considered the income of the assessee at all. The words used in section 5(1) are ‘----- total income of any previous year of a person who is a resident includes all income from whatever source derived which -----’. The words ‘from whatever source derived’ are not there as a guide to the place where the profits accrue or arise but merely to make it clear that source is irrelevant for determining chargeability under this section in the case of a resident. Section 5(2) begins in a similar manner except it deals with non-resident.

2.3 Source

Income cannot be generated from thin air. It has to be derived as a result of an activity or as a result of earning from an asset or from something which can be construed to be a source. The source can also be a combination of these i.e. a person can be carrying on a business which will generate business income and will also earn income from his personal assets e.g. shares, or letting of a house. The activity may also be in the form of work e.g. salary income. Therefore, all income must originate from a source and

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should be capable of being traced to a source. An agreement e.g. a loan agreement is also a source of income. This concept is important, especially at the time of determining whether a particular item or activity is a source of income for the purpose of section 9 of the Act which deems certain income to accrue or arise in India. Identification of the source of income is also essential to categorize the income into the respective heads of income. The concept of heads of income is discussed in greater detail in the subsequent chapters.

When one talks about the receipt, it implies some control over the income. Without such control, the income cannot be said to have parted title in favour of the recipient. Therefore, a mere entry in the books of account is not sufficient to constitute a receipt liable to tax with respect to the persons in whose name it has been credited [*CIT v. Toshoku Ltd. (1980) (125 ITR 525) (SC)*].

It may be pertinent to note the decision of the Supreme Court in the case of *Kanchanganga Sea Foods Ltd v. CIT, ITO, and Ors [(2010) 325 ITR 540]*, wherein it has been held that the remittance in kind by an Indian company to the non-resident is taxable in India if such amount has been received or accrued in India. Further, the payer in such cases is not absolved of withholding obligations, notwithstanding the fact that remittance was made in kind to the non-resident.

One may keep in mind the Supreme Court's decision in the case of *Standard Triumph Motor Co. Ltd v. CIT [(1993) 201 ITR 391 (SC)]* where it was held that the credit entry to the account of the non-resident assessee in the books of the Indian company did amount to its receipt by the non-resident assessee and was accordingly taxable, and it was immaterial when it actually received the same abroad. Therefore, the income would be taxable depending on the facts of the case and the congruence of the provisions of section 5 read with section 9. For the moment, the simple principle to be kept in mind is that receipt involves full receipt, with control over the usage and disposal of the income. Therefore, even a constructive receipt would be taxable if it satisfies that condition.

2.4 Concept of 'deemed accrual'- Section 9

The Act contemplates taxation not only on actual receipt but also on 'accrual'. 'Accrues', 'arises' and 'received' are three different situations contemplated. The term 'receipt' implies actual receipt with full control over ownership and disbursement. The words 'accrues' or 'arises' denote a right to receive. While 'accrues' may mean at a future date upon accumulation, 'arises' is more concrete & denotes that a right to receive is more immediate and tangible. Both the terms, 'accrues' and 'arises' are used in different context and are not synonymous.

The landmark decision of the Supreme Court in this connection is in the case of *E.D. Sassoon and Co. Ltd v. CIT* [(1954) (26 ITR 27) (SC)] wherein the Supreme Court has interpreted the words "accruing or arising" to mean a right to receive e.g. a debt created in favour of a person gives that person a right to receive. However, a mere claim is not a right because there is no reciprocal acknowledgement of the debt unless the claim is legally enforceable. The Supreme Court in the case of *C.I.T. v. K.R.M.T.T. Thiagaraja Chetty and Co.* [(1953) 24 ITR 525 (SC)] held that mere fact that the company was withholding payment on account of a pending dispute could not be held to mean that the amount did not accrue to the assessee. Similar view was adopted in the case of *[Babulal Narottamdas v. CIT (1991) (55 Taxman 3) (SC)]*. Concept of accrual is neutral to considerations like treatment by the taxpayer in the books of account, difficulty of recovery or non-receipt of income. The often cited decision in the case of *Hindustan Housing and Land Development Trust Ltd* [(1986) (161 ITR 524) (SC)] laid down that when the dispute is only regarding quantification of income and not the right to receive the income, the income is said to have accrued or arisen. But, where the right to receive is itself disputed, there cannot be any accrual. Therefore, as can be seen, while certain guiding principles are laid down, there is no absolute solution; every case has to be evaluated on its own facts and merits.

Section 9 has to be read in conjunction with section 5. Section 9 deems certain income to accrue or arise in India in case of a non-resident. In other words, section 9 creates a deeming fiction and lays down circumstances where income will be deemed to accrue or arise in India. It deals with both, residents and non-residents and various categories of income. Section 9(1) inter-alia covers income accruing or arising from business connection in India or from any property in India or source of income in India or through or from

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any capital asset situated in India. It also covers salary income, dividend, interest, royalty, fees for technical services (FTS), and any sum of money referred to in section 2(24)(xviii) received by a non-resident. As these are in connection with a non-resident, they are restricted to income which arises or is deemed to accrue or arise in India.

There has been whole lot of dispute and plethora of case laws on what can be considered a business connection or a source of income or asset in India.

2.5 Business connection

Earlier the term business connection was not defined in the Act. The Finance Act 2003, with effect from 1.4.2004 inserted Explanation 2 to section 9(1) of the Act.

Explanation 2 to section 9(1) of the Act provides as under:

“....."business connection' shall include any business activity carried out through a person who, acting on behalf of the non-resident,-

- (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or*
- (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or*
- (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:*

Provided *that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business:*

Provided *further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principle non-resident or are*

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subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.”

The definition of business connection as provided by the explanation above was more or less in line with the definition of an “agency P.E.” in the DTAAAs. However, with the development of different business models over the years and the modification of the PE rule as recommended in BEPS Action Plan 7, the definition of business connection was further amended vide Finance Act 2018.

With effect from 1.4.2019, clause (a) to the Explanation 2 to section 9(1) of the Act reads as under:

...it is hereby declared that “business connection” shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

- (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are—*
 - (i) in the name of the non-resident; or*
 - (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or*
 - (iii) for the provision of services by the non-resident; ...*

With the amended definition, an agent of a non-resident would include not only a person who habitually concludes contracts on behalf of the non-resident, but also a person who habitually plays a principal role leading to the conclusion of contracts, thus extending the scope of business connection through agent.

The concept of Agency P.E in the DTAA and the BEPS Actions Plan have been dealt with exhaustively later and is, therefore, not discussed in this Chapter.

The landmark decision in the context of business connection is the case of *R.D. Agarwal and Co. [(1965) 56 ITR 20 (SC)]* wherein the Supreme Court noted that there can be said to be a business connection when there is a nexus between the business carried on by a non-resident which yields

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profit, and the activity carried on in India which contributes to such profits or gains. It gives some element of continuity between the business and the activity in India. The connection must be real and intimate.

For a long time, nexus based on physical presence such as a branch, a factory or an exclusive agency was considered as apt example for business connection. The Kolkata Tribunal while examining the taxability of advertisement revenue of Google Ireland and Yahoo USA in India in the case of Right Florists Pvt Ltd [(2013) 143 ITD 445 (Kol)] observed that there was no evidence to suggest or demonstrate that the advertising revenues generated by Google Ireland and Yahoo USA were supported by, serviced by or connected with any entity based in India. Hence, a business connection could not be established in India and receipts of Google Ireland and Yahoo USA could be not taxed in India under Section 9(1)(i).

However, with the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged. Under these new business models, the non-resident enterprises interact with customers in another country without having any physical presence in that country. For instance, social-media websites like Facebook, Instagram, Twitter etc. or subscription-based websites like Netflix, Amazon Prime, Westlaw, or on-line businesses like Airbnb, Uber or search engines (which work as advertising portals) like Google, Yahoo et al. generate significant revenue in India even though such businesses do not necessarily need an office space in India to serve Indian customers. These businesses generally operate through a server located outside India without establishing any real physical presence within the country and hence, fall outside the purview of tax laws which have limited extraterritorial reach.

The existing nexus rule based on physical presence does not hold good anymore for taxation of business profits. In order to protect the rights of the source country to tax business profits that are derived from its economy, the concept of business connection through 'significant economic presence' ('SEP') was introduced in the Act by Finance Act 2018. However, provisions were not effective in the absence of notification laying down monetary and user threshold.

On global front, taxation of Digital Economy is an ongoing debate under OECD BEPS Profit Action 1 and is expected to reach global consensus measure by end of 2020. Consequently, India has deferred the applicability of SEP provisions to FY 2021-22.

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Provisions relating to Significant Economic Presence (as amended by Finance Act, 2020)

As per explanation 2A to section 9(1) of the Act, it has been declared that significant economic presence of a non-resident in India shall constitute 'business connection' in India.

In this regard, 'significant economic presence' has been explained to mean

- (i) transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
- (ii) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed:

Further, the aforementioned transactions or activities shall constitute significant economic presence whether or not (i) the agreement for such transactions or activities is entered in India; or (ii) the non-resident has a residence or place of business in India; or (iii) the non-resident renders services in India.

Accordingly, emerging businesses which rely heavily on digitization of business operations and do not require a physical presence of itself or any agent in India, are now made liable to tax in India through a significant economic business connection in India.

After establishing whether or not there is a business connection or that the income is or can be deemed to accrue or arise in India, i.e., once the taxability under the Act is established, then the question to be asked is; whether any relief is available under the DTAA e.g. in the case of interest income, the DTAA may provide that it is not taxable in India or may provide that it is taxable at a reduced rate. It is now established beyond doubt that if the provisions of the DTAA are more beneficial, the income has to be taxed under the DTAA. [*Circular No 333 dated 24 April 1982 issued by the Central Board of Direct Taxes, CIT v. Vishakapatnam Port Trust [(1983) (144 ITR 146)] and UOI v. Azadi Bachao Andolan [(2003) 263 ITR 706]* referred to earlier]. The Explanation to section 9(1) clarifies that in the case of a business of which all the operations are not carried out in India, only such part of the income

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as is reasonably attributable to the operations carried out in India shall be deemed to accrue in India under this clause.

Section 9 creates a fiction to bring into the tax zone, certain specified income. What is actually received in India is taxed on a 'stand-alone' basis and not under section 9. This fiction of section 9 comes into play only when the income is not charged to tax on the basis of receipt in India, as receipt of income in India by itself attracts tax whether the recipient is a resident or non-resident. However, to bring the income to tax, a territorial nexus with the income and the person sought to be taxed is to be established. The territorial nexus doctrine plays an important part in the assessment of tax. Income arising out of operations in more than one jurisdiction would have territorial nexus with each of the jurisdiction on actual basis. If that be so, it would not be correct to contend that the entire income 'accrues or arises' in each of the jurisdiction [*Ishikawajma-Harima Heavy Industries Ltd. v. DIT (2007) (158 Taxman 259)*].

Section 9(1) clause (i) deems all income accruing or arising 'whether directly or indirectly, through the transfer of a capital asset situated in India'.

A landmark ruling of the Supreme Court in the case of *Vodafone International Holdings B.V. [(2012) (17 taxmann.com 202) (SC)]* held that the transfer, by a non-resident to another non-resident, of shares of a foreign company holding an Indian subsidiary Company [more often known as 'indirect transfer'] does not amount to transfer of any capital asset situated in India. Accordingly, the gains arising from the said transaction were not liable to tax in India. Thus, the Apex Court concluded that the legal fiction has a limited scope and cannot be expanded to give purposive interpretation. This is particularly if the result of such an interpretation would seek to transform the very basis of the concept of chargeability of the section.

As a result of this decision, the Finance Act, 2012 inserted Explanation 4 to section 9(1)(i) with retrospective effect from 1 April 1962 clarifying that the expression 'through' shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of". Explanation 5 further, clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

The provision was construed to be draconian considering its wide scope (applicability being retrospective) and language as well as lack of clarity on

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mainly on what would be considered to be deriving value substantially from Indian assets.

The Finance Act, 2015 clarified that the share or interest of a foreign company or entity shall be deemed to derive value substantially from Indian assets (tangible or intangible) only if the value of Indian assets as on the specified date:

- exceeds the amount of Rs. 10 crores; and
- Represents at least 50% of the value of all the assets owned by the foreign company or entity.

Accordingly, where the value of Indian assets is below Rs. 10 crores or represents at least 50% of the value of total assets of the foreign company or entity, transfer of shares of such company or interest in such entity should not be chargeable to tax in India. Subsequently, vide Finance Act 2017, assets or capital assets, which are held by a non-resident by way of investment, directly or indirectly, in Category-I or Category-II foreign portfolio investor under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014, made under the Securities and Exchange Board of India Act, 1992 (15 of 1992) have been excluded from the purview of indirect transfer provisions.]

Moving on from the first clause in section 9(1) which inter-alia dealt with business income and indirect transfers to the second clause i.e. section 9(1)(ii) & (iii) which deals with taxation of salary income. 'Salary income' is taxable in India if it is earned in India. While this clause may appear simple, it has also created a plethora of litigation as to the quantum of the salary income to be considered as 'earned' in India. A long drawn battle was regarding taxability of off-period salary i.e. salary paid to a non-resident, otherwise rendering service in India, while he is on leave or rest period. The argument was that the salary paid abroad cannot be deemed to accrue or arise in India, however, the Finance Act 1999, w.e.f. 1 April 2000, inserted an *Explanation* to section 9 (1)(ii) of the Act to provide that the rest period or leave period salary will be taxable in India.

Other clauses in section 9(1) deals taxation of dividend, interest, royalty, Fees for Technical Services (FTS), sum of money or property received by a non-resident (not being a company or foreign company) from a resident in India. These are dealt with in detail in Chapter 3.

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The clauses which have caused a lot of disputes between the taxpayer and the tax authorities are the clauses 9(1)(vi) & 9(1)(vii) dealing with taxation of royalty and FTS. Mainly, the dispute revolves around whether the income constitutes 'royalty' or FTS or 'business income' and also whether the services rendered from outside and utilized in India will be taxed in India or only the services rendered in India and utilized in India shall be taxable in India. In this regard, the Supreme Court in the case of *Ishikawajima Harima Heavy Industries Limited v. DIT* [(2007) (288 ITR 408) (SC)] held that for services to be taxable in India, the services not only have to be utilized within India but also be rendered in India or have such a "live link" with India that the entire income from fees becomes taxable in India. However, subsequently, the Act has been amended w.r.e.f 1 June 1976, to provide that income of a non-resident from rendering services in the nature of 'interest', 'royalty' and 'FTS' are deemed to accrue or arise in India irrespective of whether the non-resident has a place of business, residence or business connection in India or services are rendered in or outside India.

The Mumbai Tribunal also, in the case of *Linklaters v. ITO* [(2010)(132 TTJ 20)] based on the amendment has held that as long as the services are utilised in India, the income is deemed to arise in India irrespective of the fact that services are rendered outside India. Therefore, entire fees for professional services earned by the taxpayer in connection with the projects in India are taxable in India under the Act.

The effect of clause (vi) and (vii) is merely to deem income to accrue in India when it, in fact, accrues abroad, but these clauses do not deem any capital receipt to be income. Therefore, if the royalty or FTS is on capital account, it is not within the ambit of this section. The agreement in this regard has to be studied carefully and must establish a sufficient nexus with the income and the accrual in India.

In case of FTS, as long as the services are utilized in a business carried on in India, it would be taxable in the hands of the non-resident. It is the nature of the payment that is to be seen and not the nomenclature given by the parties. In the case of *GVK Industries Ltd v. ITO* [(2015) (371 ITR 453) (SC)], a success fee was also held to be in the nature of FTS.

These clauses in section 9 are specific to deem certain income like royalty, interest or FTS to accrue or arise in India. Where income cannot be deemed to accrue or arise in India under these clauses, it cannot be deemed to

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accrue or arise at all by forcing it to fit within clause (i) of section 9(1). [*Meteor Satellite v. ITO (1980) (121 ITR 311), CIT v. Copes Vulcan (1987) (167 ITR 884)*]

2.6 Residential status and control and management

Taxation is with reference to the income of a person derived in a relevant previous year. The 'person' is further classified as 'resident' or 'non-resident'. The definition of 'resident' is under section 6. This section lays down technical and artificial tests to determine the territorial connection to justify taxability of a person. The section is divided into three parts, sub-sections 1 and 6 deals with individuals, sub-section 2 deals with HUF, firm or association of persons, sub-section 3 deals with company, sub-section 4 deals with every other person i.e. artificial juridical person e.g. statutory corporations and idols, sub-section 5 is clarificatory to state that the residential status applies to all sources of income.

2.6.1 Individuals

The test to determine the residential status of an 'individual' is based on the number of days of stay in India. Therefore, even a day or two here and there could make a fundamental difference. The category of residents is further divided into; (i) resident and ordinarily resident; (ii) resident but not ordinarily resident; and (iii) non-resident. Section 6 of the Act only states what constitutes a 'resident' and a 'not ordinarily resident'. If the person does not fall into either category, he would be a 'non-resident', the definition of which is provided in section 2(30) of the Act.

The test of residence in section 6(1) is based on the physical presence in India. This test has to be carried out each year. The tests of residence (as provided below) in section 6(1) are alternative and not cumulative. The physical presence is in connection with the territorial jurisdiction of India and therefore, even stay on a yacht within the territorial waters of India would constitute the physical presence in India. A person can be a resident of one or more countries because work may require a person to travel, however, the country of origin or domicile will always be one. This is, in fact, where DTAA's come in to decide the country of which a person can be considered as 'resident' for the purpose of taxation. Though a source country can get a territorial right to tax the income, the country of residence will have to give credit for taxes abroad while taxing the global income.

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As per existing section 6(1), an individual is considered as resident in India in a financial year if:

- (a) he is in India for 182 days or more during the year; or
- (b) he has been in India for 365 days or more during the 4 immediately preceding years and for 60 days or more during the financial year.

Explanation 1(b) to section 6 provides that in respect of an Indian citizen and a person of Indian origin who visits India during the year, the period of 60 days as mentioned in (b) above shall be substituted with 182 days. Explanation 1(a) to section 6 also provides similar concession to the Indian citizen who leaves India in any previous year as a crew member or for the purpose of employment outside India.

The Finance Bill, 2020 (as presented on 1st February 2020) proposed an amendment to the Explanation 1(b) that the concession in the period of stay in India, for an Indian citizen and a person of Indian origin, shall be reduced from 182 days to 120 days. Further, at the time of enactment, Finance Act, has restricted the application of amended provisions of Explanation 1(b) only to that Indian citizen or a person of Indian origin whose total income, other than income from foreign sources, exceeds Rs. 15 lakhs during the previous year. For this provision, income from foreign sources means income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India).

As per section 6(6) an individual will be 'not ordinarily resident' if, he has been a non-resident in 9 out of 10 previous years preceding that year; or during seven previous years preceding that year has been in India for a period amounting to 729 days or less. Further, section 6(6) has been amended by Finance Act 2020 and has inserted the following two more situations wherein a resident person is deemed to be 'Not Ordinarily Resident' in India:

- (a) An Indian Citizen or a person of Indian origin whose total income (other than income from foreign sources) exceeds Rs. 15 lakhs during the previous year and who has been in India for a period of 120 days or more but less than 182 days;
- (b) An Indian Citizen who is deemed to be resident in India as per new Section 6(1A)

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On account of the Covid-19 pandemic, the CBDT has recently introduced some relaxations on account of residency rules under section 6 of the Act for individuals who came to India in Financial Year 2019-20 for a visit and had to extend their stay in India due to the lockdown and consequent suspension of international flights in view of the COVID 19 situation.

The relief is applicable to individuals who came to India on a visit before 22 March 2020. In case of such individuals, the CBDT has announced exclusion of a certain number of days while determining the residential status for FY20:

- Individuals unable to leave India before 31 March 2020: The physical presence in India from 22 March 2020 till 31 March 2020 to be excluded.
- Individuals quarantined in India on or after 1 March 2020: The physical presence in India from the date of quarantine to the date of departure or till 31 March 2020, shall not be considered.
- Individuals who have departed on evacuation flight on or before 31 March 2020: The physical presence from 22 March 2020 till date of departure not to be considered.

In the case of foreign-bound ships where the destination of the voyage is outside India, there was uncertainty with regard to the manner and basis of the determination of the period of stay in India for crew members of such ships who are Indian citizens. In view of the same, the Finance Act, 2015 amended the Act to provide that in the case of an Individual, being a citizen of India and a member of the crew of a foreign-bound ship leaving India, the period or periods of stay in India shall, in respect of such voyage, be determined in the manner and subject to such conditions as may be prescribed. CBDT notified new rules clarifying that the period of stay of seafarers outside India will be calculated from the date stamped on their continuous discharge certificate (CDC) (a seafarer's identity document) at the time of joining the ship for the voyage till the date entered in the CDC at the time of signing off.

Only an 'individual' or an 'HUF' can be classified as 'not ordinarily resident'. In the case of all other 'persons', they can either be 'resident' or 'non-resident'.

Deemed Residency Rule introduced by Finance Act 2020

Finance Act 2020 has introduced a new section 6(1A) in the Act. As per the section, an individual, being a citizen of India, having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the

previous year, shall be deemed to be resident in India in that previous year, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

2.6.2 Firms, AOPs, and HUFs

In the case of HUFs, firms and AOPs the test revolves around where the head and the brain is located. An HUF, firm or AOP is resident in India if the control and management of its affairs are situated wholly or in part in India. If the control and management of these entities is situated wholly outside India, it is not a resident for the purpose of taxation. Hence, a firm, HUF or AOP can also have a residence in one or more countries.

The control and management is dependent on where the head and the brain is located i.e. the persons who can be considered to be the ones making the decisions which in the case of an HUF would be a Karta, and in the case of a company would be the board of directors. [*Erin Estate, Gallah, Ceylon (1958) (34 ITR 1) (SC) & Nandlal Gandlal (1960) (40 ITR 1) (SC)*].

Control does not necessarily mean where the trading activities are carried out; nor is the business managed from a place where the accounts are drawn up, or profits are distributed. Control and management implies directing the flow of resources and deciding the strategy and tactical moves with a long-term growth prospect of the entire company and not just a particular territory.

2.6.3 Company

Erstwhile, two alternative tests were provided for determining the residence of the companies. A company was considered to be a resident if it was an Indian company or if the control and management of its affairs was situated wholly in India in the accounting year. Thus, every Indian company is a resident Indian. A point of distinction in the test of residence between HUF, firm, AOP and company was that, in the case of the former partial control and management in India was sufficient to constitute a 'resident', whereas in the case of a company the control and management must be wholly situated in India. Again, as in the case of an individual, a company can have more than one residence but the country of 'origin' so to say is important for elimination of double taxation.

The Finance Act, 2015 amended section 6 sub-section 3 of the Act with respect to the test of residence in case of companies w.e.f. 1 April 2016. It was observed that due to the requirement that whole of the control and

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management should be situated in India and that too for the whole of the year, the condition had been rendered to be practically inapplicable. A company could easily avoid becoming a resident by simply holding a board meeting outside India. This facilitated the creation of shell companies that were incorporated outside India but controlled from India. In view of this, the Finance Act, 2015 introduced the internationally recognized concept for determination of residence of a company incorporated in foreign jurisdiction viz. 'Place of Effective Management' (POEM). Further, POEM was defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made. In order to provide clarity in respect of the implementation of POEM based rule of residence and also to address concerns of the stakeholders, the Finance Act, 2016 deferred the applicability of POEM based residence test by one year. Accordingly, it became applicable from 1 April 2017.

The Explanatory Memorandum to the Finance Bill, 2015 had stated that since POEM is an internationally well-accepted concept, there are well recognised guiding principles for determination of POEM although it is a fact dependent exercise. A set of guiding principles for determination of POEM, were issued for the benefit of the taxpayers as well as, tax administration on 24 January 2017. It has been clarified that POEM guidelines as well as section 6(3)(ii) shall not apply to a company having turnover or gross receipts of INR 50 Crores or less in a financial year.

The residential status of all taxpayers may change from year to year and therefore, must be examined each year afresh.

2.7 Jurisdictional test in India

The power to levy and collect tax is derived from the Constitution of India. The Act also derives authority from the Constitution. The important provisions of the Constitution are Article 265 which states that '*No tax shall be levied or collected except by authority of law*' and Article 246 gives the authority to legislate to the Union and the States. A taxing statute can also be challenged on the ground that it contravenes any of the fundamental rights guaranteed by the Constitution. However, unless a provision is struck down by the Court as being *ultra vires*, there is a presumption that it is *intra vires* the Constitution. The Act is an exhaustive self-contained code.

To establish taxability, there must be a link or a territorial connection between the person sought to be charged and the country seeking to tax him.

Broad Features of the Income Tax Act, 1961

If that connection is real and substantial even a non-resident is liable to tax in respect of his Indian income. This is where, the DTAA's come into play, to reduce or eliminate such taxation. However, as we saw it is the source rule which is predominant in most countries and therefore while double taxation may not be eliminated it will be reduced and credit for foreign taxes will be available in the country of residence.

There are certain provisions, like section 9, which extend the territorial operation by way of fiction to deem certain income to accrue or arise in India.

The Act extends to the whole of India. The Finance Act, 2007 amended the definition of India to mean the territory of India as referred to in Article 1 of

the Constitution, its territorial waters, seabed and subsoil underlying such water, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 (80 of 1976) and air space above its territory and territorial waters. Every country has an extended zone which extends the boundary beyond the natural geographical limits. The Indian territorial waters limit is 12 nautical miles from the nearest point of the appropriate base line. This limit is important to extend the territorial scope of taxation especially in the case of oil and exploration activities. The sovereign of India extends to the territorial waters of India. Beyond the territorial waters, India has limited sovereign rights in respect of the sea-bed up to a distance of 200 nautical miles, which is known as the Continental Shelf and sea or waters over the continental shelf which is the Exclusive Economic Zone (EEZ). The limited sovereign rights do not extend the sovereignty of India over the Continent Shelf or EEZ.

2.8 Heads of income

Section 1 defines the territorial scope of the Act. Section 4 is the charging section while section 5 defines the scope of total income which has to be read along with section 9. Section 14 provides that all the income, for the purpose of charge of income-tax and computation of total income should be classified into five 'Heads of income'. This allows rules for computation to be specified for each source of income. Currently, the Heads of Income are:

- A Salary,
- B Income from house property,

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- C Profits and gains of business or profession,
- D Capital gains,
- E Income from other sources.

All the heads are clubbed under Chapter IV with sub-chapters A-F. The mode of computation is specified in sections under each chapter.

The purpose of section 14 is not to levy a charge on income but to organize the mode of computation of income. The tax is charged on the total income of all the heads after considering the deductions allowed and set-off losses as stipulated. The income must be correctly classified and brought to tax under the head it belongs to. Certain incomes may be classifiable under two heads e.g. interest, may be from the business or casual income. In that case, the source which is the closest must be considered e.g. if it forms part of business profits it will be assessed as business income and; if it is surplus cash invested, it may be assessed as 'income from other sources'. In fact, this classification causes a lot of dispute especially in the case of deduction claims e.g. for the purpose of section 10AA it would be essential to determine whether the interest income forms part of 'business income', eligible for deduction or will be taxed as 'income from other sources of an assessee.

Income from other source is a residuary head of income but, if income falls under a particular head, it cannot be placed into the residuary head. To decide which head the income ought to fall into the nature of income is important. Likewise, the expenses also have to be matched to the income and must be deducted only against that head of income and not any other.

TAXATION OF NON-RESIDENTS

3.1 Foreign income and foreign tax payers - Categories of income

As we saw in the earlier chapter for the income to be taxed in India it must be received / accrued in India, or must be deemed to accrue or arise in India. In the case of non-residents or foreign entity it is important to establish the nexus between the income sought to be taxed and the taxable jurisdiction of India. Once the jurisdiction to tax the income is established, the DTAA with the country of the non-resident may be looked at to reduce or nullify the tax liability.

We shall briefly examine the categories of income that could arise to a foreign entity. These are discussed at length in Chapter 5.

3.1.1 Royalties and FTS

The definition of 'royalty' and FTS is contained in section 9(1) (vi) and (vii) respectively.

The definition of 'royalty' is very vast and includes inter alia any consideration, including any lump sum consideration received for allowing another person the use of any patent, model, design, industrial equipment etc. or; consideration received for transfer of all or any rights in the model, design, patent, copyright, literary work etc. It however, does not include any consideration which is chargeable as income under the head "capital gains" in the hands of the recipient. The Finance Act 2012, made a series of retrospective amendments to the definition of royalty and thereby substantially expanded the scope of the term royalty.

The definition of 'FTS' in section 9(1)(vii) means any consideration received for rendering of any technical, managerial or consultancy services but does not include income which would be chargeable under the head 'salaries' or consideration for any construction, assembly, mining projects.

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With regard to the provisions of the Act, Section 9(1) (vi) and (vii) define the scope of royalty and FTS and in what situations can they be said to be deemed to accrue or arise in India to bring them within the tax net.

As regards the DTAA's, each DTAA will have its own definition of royalty and FTS. The provisions in respect of Royalties and Fees for Technical Services ('FTS') are generally contained in Article 12 of the DTAA's.

It may be interesting to note that the Act uses the term 'Royalty' whereas the DTAA's the term 'Royalties' is used. In this publication, these terms have been used interchangeably.

In most of the DTAA's, the taxability of royalties and FTS is discussed in the same article. However, in some of the new DTAA's being negotiated FTS is covered in a separate Article after royalties. In some tax treaties the concept of FTS is not present at all and in some treaties, FTS is referred to as FIS (Fees for included Services). The definition of royalties under the DTAA's is a truncated one as compared to the provisions of the Act. In some DTAA's the scope of FTS is restricted through the "make available" concept.

All the above provisions have been dealt with in a greater detail in a separate Chapter on Royalty and FTS

In order to determine whether the given payment qualifies as royalty / FTS, the provisions of the Act and of the concerned DTAA would have to be considered. Another relevant factor for determining the taxability of Royalty and FTS shall depend upon whether the non-resident has a PE / fixed place of profession in India or not.

Taxability as per the provisions of the Act

Where the non-resident does not have a PE / fixed place of profession in India to which the royalty / FTS income is effectively connected, the royalty / FTS would be taxable on gross basis as per section 115A of the Act at the rate of 10%¹ plus applicable surcharge and cess.

Where the non-resident has a PE / fixed place of profession in India to which the royalty / FTS income is effectively connected, the taxability of Royalty / FTS shall be governed by section 44DA of the Act.

As per the provisions of section 44DA of the Act, royalty / FTS received by a non-resident from the Government / Indian concern under agreements

¹ As per Finance Act 2015 w.e.f. 1.4.2016

Taxation of Non-Residents

entered after 31st March, 2003² and effectively connected to a PE / fixed place of profession in India would be computed under the head “business income”. Accordingly, income would be arrived at after reducing permissible expenses as per provisions of the Act. In computing this income, no deduction shall be allowed for –

- Expenditure which is not wholly and exclusively incurred for the business of the PE / fixed place of profession in India; or
- Amount paid by the PE to its head office / any of its other offices (other than actual reimbursement of expenses).

Further, the non-resident would be required to compulsorily maintain books of accounts as per section 44AA of the Act and get the accounts audited. The tax rate applicable under section 44DA of the Act is 40% (plus applicable surcharge and health and education cess).

Further, if the royalty/FTS is received from a non-resident (i.e., not from the Government or an Indian concern), the applicable tax rate would be 40% (plus applicable surcharge and health and education cess). However, in such a scenario, the benefit of net basis of taxation would be available.

Taxability under the DTAA

The applicable article of the DTAA generally prescribes rate for taxability of royalties / FTS / FIS covered within its fold. Similar to the treatment provided in section 115A of the Act, royalties or FTS /FIS not attributable to a PE in India of the non-resident recipient would be taxable on gross basis (as per relevant provisions of the DTAA). Most DTAA's India has entered into provide for a tax rate in the range of 10-15%³. In such a scenario, the assessee has an option to apply the tax rate prescribed in the applicable DTAA or section 115A of the Act, whichever is more beneficial to it, in accordance with section 90(2) of the Act.

Further, in a situation where the royalties/FTS is attributable to a PE in India of the non-resident, the income liable to tax would be computed on net basis as per relevant Articles of the DTAA (i.e., Article 5 {dealing with PE} read with Article 7 {dealing with Business Profits} in most cases). The tax rate applicable in such a scenario would be 40% (plus applicable surcharge and health and education cess).

² Before April 1, 2003, taxability was governed by section 44D of the Act

³ Surcharge and education cess would not be leviable on such a rate

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For determining the characterization of a payment into Royalties / FTS, as well as the taxability of the same, provisions of the Act, or the respective DTAA, whichever is more beneficial shall apply.

Further, it should be noted that the main complication arises not in the determination of the situs of taxation, but on the interpretation of the definition. The tax authorities would always endeavor to classify the payment as towards 'royalties' or FTS whereas the taxpayer would try to negate that by contending that it is business income and not taxable in the absence of a PE. The debate is typically more conflagrated in case of determination of Royalty. And there is a classic battle as to whether the payment is for the 'use' or for the 'sale' of the technology.

The complexity of the issue can be gauged from the fact that the Courts themselves have not been able to come to a common conclusion. The Karnataka High Court in the case of CIT vs Samsung Electronics Co. Ltd. [2012] 345 ITR 494 (Kar) has held that payment for off the shelf software amounts to royalty not only under the Act, but also under the US treaty.

However, the Delhi High Court in the case of DIT vs Infrasoftware Ltd. [2013] 39 taxmann 88 (Del) has expressed a disagreement with the decision of Karnataka High Court in Samsung's case and observed that the license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use was only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purposes and is not royalty. In the case of DIT vs Nokia Networks OY [2012] 25 taxmann 225 (Del), the Delhi High Court held that there is a clear distinction between royalty paid on transfer of copyrights and consideration for transfer of copyrighted articles.

Similar complications are discussed in detail in the chapter 5 under the section dealing with royalty/FTS.

3.1.2 Shipping income

From the commencement of trade in the ancient times to the modernization of trade in the supersonic age, the shipping industry has gone from strength to strength. Recognizing the fact that it is not very practical for non-residents engaged in shipping business who have no other source of income in India to maintain exhaustive books of account, section 44B of the Act provides for a deeming provision for computing the profits of a non-resident engaged in the business of operation of ships. A sum equal to seven and a half percent of

the aggregate of the amount received on freight income and ancillary receipts like demurrage or handling charges is deemed to be the income of the non-resident and the prevailing rate of tax is applied to the deemed receipts.

To make the Indian shipping industry more competitive, a tonnage tax scheme for taxation of shipping companies was introduced by the Finance Act, 2004.

Here again where the non-resident belongs to a Treaty country he can avail of the benefits of the DTAA if it is more beneficial. It is generally understood that the country of residence would reserve the right to tax the shipping income. However, in some DTAA's the source country is given a right to tax the income at a reducing rate for certain years for e.g. say 50 percent in first five years 25 percent for next five years and fully exempt from the eleventh year. In order to prevent shipping companies from registering themselves in countries where shipping income is exempt whilst carrying on business in another country some DTAA's stipulate that income will be taxed in the country of effective management i.e. in the country from which the business is controlled.

3.1.3 Income from exploration of minerals

In the case of non-residents engaged in the business of providing services or facilities in connection with, or supplying plant and machinery on hire to be used in the prospecting for, or extraction or production of, mineral oils in India, section 44BB of the Act provides a deeming fiction; deeming ten percent of the receipts (whether paid or payable in or out of India and the amount received or deemed to be received in India) on account of provisions of such services and facilities to be the income of the non-resident. Here again the rationale being to spare the non-resident who doesn't have income from any other source in India from maintaining detailed books of account. However, the taxpayer can claim to be taxed on net income basis if, the taxpayer maintains books of account as specified under section 44AA of the Act and the books of account are audited under section 44AB of the Act in India.

In this case also if the provisions of a DTAA are more beneficial, relief under DTAA may be claimed. The definition of a PE would always include a mine, an oil or gas well or any other place of extraction of natural resources. This is discussed a little more in detail in the Chapter 5 under the section dealing with PE.

3.1.4 Income from operation of aircrafts

In the case of non-residents engaged in the business of operation of aircrafts section 44BBA of the Act provides a deeming fiction; deeming five percent of the receipts (whether paid or payable in or out of India and the amount received or deemed to be received in India) to be the income of the non-resident on which tax is levied at the prevailing rates in force. The taxpayer can claim to be taxed on net income basis if the taxpayer maintains books of account and the books of account are audited in India. Here again resort may be had to the provisions of a DTAA if they are more beneficial. It is generally understood that the country of residence would reserve the right to tax such income. However, in some DTAA's the source country is given a right to tax the income at a reducing rate for certain years.

3.1.5 Income from turnkey power projects

Foreign companies engaged in specified activities in connection with the execution of turnkey power projects contracts approved by the Central Government and financed under an international aid program are subject to tax on a deemed profit of ten percent of gross revenue paid or payable in or out of India under section 44BBB. The taxpayer can claim to be taxed on net income basis if the taxpayer maintains books of account and the books of account are audited in India.

Though the instructions issued by the tax department are only binding on the department and not on the courts, it may be worthwhile to note that the Central Board of Direct Taxes ('CBDT') has withdrawn Instruction no.1829, dated 21 September 1989 which laid down guidelines for determining the taxability of income arising to non-residents from execution of power Projects on turnkey basis to be carried out in India as well as outside India. CBDT has issued Instruction no.5, dated 20 July 2009 withdrawing the above referred Instruction.

Taxability of turnkey contracts has always been a matter of debate. In the case of an identifiable segment of a composite contract with a non-resident, the income pertaining to activities carried out in India can only be attributed to the Indian operations for the Indian tax purposes. In other words, the offshore supply contract does not attract tax liability in India. The Hyderabad Tribunal in a ruling on the taxability of the composite contract in the case of ACIT v. Andhra Pradesh Power Generation Corporation Ltd. (2009-TIOL-346-ITAT-HYD) held that though the contracts were of composite in nature,

tax was required to be deducted only on income attributable to the identifiable segment of the composite contract which was carried out in India.

The decision of the Supreme Court in the case of *Ishikawajima Harima Heavy Industries v DIT (2007) 288 ITR 408 (SC)* is also a landmark decision in the context of offshore/onshore contracts. The SC ruled that the income of a non-resident from offshore supply of equipment and services outside India will not be taxable here merely because it was supplied to a turnkey project located in India. The ruling was given to Japanese MNC Ishikawajima-Harima Heavy Industries, a partner in the Petronet consortium. The company had appealed against a ruling by the AAR. The project was in Gujarat and the contract was a composite one, entailing onshore and offshore supply of equipment and services. The dispute was on the taxation of offshore supplies. The essence of SC's verdict was that merely because the project was located in India, it does not render sufficient nexus to tax income on supply of offshore equipment. More so, when no operations were carried out here. Also, the SC held that the company had rendered services outside India. So the income earned from these services cannot be attributed to a PE in India and taxed here. Simply put, two conditions need to be fulfilled for levying a tax. One, the services should be used in India. Two, it should be rendered here as well.

However, the Act was amended by the Finance Act, 2007 and further amended by the Finance Act 2010, to provide that income of a non-resident from rendering services in the nature of interest', 'royalty' and FTS are deemed to accrue or arise in India irrespective of whether the non-resident has a place of business, residence or business connection in India or services are rendered in or outside India. This amendment applies retrospectively from financial year 1976-77.

The evolution of jurisprudence on taxability of offshore contracts is discussed in more detail in Chapter 5.

3.1.6 Dividend and interest

Where the income of a non-resident or a foreign company includes dividend, income (other than dividends referred to in section 115-O of the Act)⁴, or dividend on units of mutual fund purchased in foreign currency or interest income in respect of monies borrowed or debt incurred by the Government or

⁴ This shall be omitted with effect from April 1, 2021

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Indian concern in foreign currency, section 115A of the Act provides that the income will be taxed at the rate of 20 per cent. Certain specific interest income (from infrastructure debt fund as per section 10(47), interest specified under section 194LC and section 194LD section 194LDA (2)) is chargeable at the rate of 5%. The dividend on which dividend distribution tax has been withheld would be exempt from tax, as per existing domestic law. However, it may be important to note that the Dividend Distribution Tax has been abolished by the Finance Act, 2020. Hence, all dividend income distributed will be taxable in the hands of the shareholders.

Here again relief under beneficial provisions of a DTAA may be availed. Taxability of interest and dividends from certain specified instruments is discussed in the following paragraph.

3.1.7 Income from Bonds or Global Depository Receipts purchased in foreign currency

As per the provisions of section 115AC of the Act, where total income of a non-resident includes:

- Interest on bonds issued under Foreign Currency Exchangeable Bond Scheme, 2008
- Interest on bonds issued under Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Deposit receipt Mechanism) Scheme, 1993 or Depository Receipts Scheme 2014
- Interest on bonds of a Public Sector Company sold by the government and purchased by him in Foreign Currency;
- Dividend on Global Depository Receipts issued in accordance with specified scheme or other specified manner
- Long term capital gains on above-said bonds / Global Depository Receipts

The income tax payable shall be calculated at the rate of 10% of the above said incomes. Further, no deduction shall be available against such incomes under:

- Sections 28 to 44C
- Section 57 – clause (i) and clause (iii)
- Chapter VI-A

Also, for the purpose of calculating above-said capital gains, nothing contained in first and second proviso to section 48 of the Act shall apply.

3.1.8 Tax on non-resident sportsmen or sports association or entertainer

As per the provisions of section 115BBA of the Act, the following incomes shall be taxed at the rate of 20% on a gross basis:

- In case of a non-resident sportsman who is not a citizen of India
 - Income from participation in India in any game / sport (other than that covered under 115BB);
 - Income from advertisement;
 - Income from contribution of articles relating to any game or sport in India in newspapers, magazines or journals
- In case of a non-resident sports association / institution, the amount guaranteed to be paid to them in relation to any game / sport played in India (other than that referred to in section 115BB)
- In case of a non-resident entertainer who is not a citizen of India, any income from his performance in India.

Further, if their total income consists only of income as referred to aforesaid and the tax deductible therefrom has been deducted at source, then, it shall not be necessary for them to furnish their Return of Income in India.

3.2 Withholding tax

The obligation of a tax payer to pay tax is met either by him paying the tax himself, i.e. by way of advance tax or by way of self-assessment tax, or by way of tax deducted at source by the recipient of the goods/service on taxpayers' behalf.

There are certain instances where the payer is obliged to withhold taxes from payments made to the non-residents (illustrative list):

- Payments in the nature of Royalty for use or right to use any immovable property.
- Payments in the nature of FTS
- Payments in the nature of Capital Gains from sale or transfer of Indian assets

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- Payments in relation to Permanent Establishment of the non –resident.
- CBDT has clarified vide Circular No 152 dtd 27-11-1974 that the objective behind application of TDS provisions to non-residents as per provisions of section 195 is three fold:-
 - to ensure that the tax is collected at the earliest point of time;
 - there is no difficulty in collection of taxes at the time of assessment; and
- avoiding loss of revenue since the non-residents may have no assets in India for subsequent recovery.

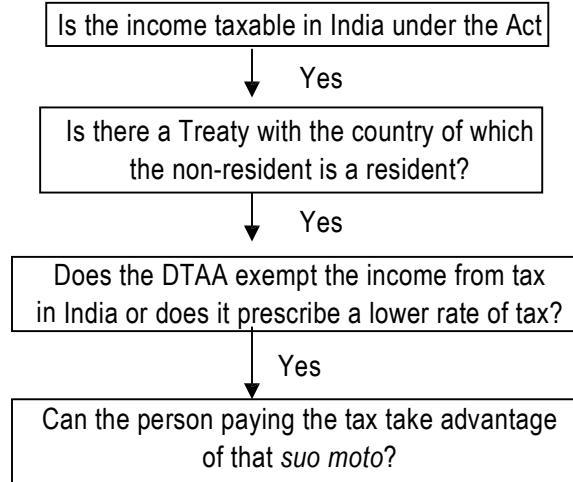
Timely and accurate collection of tax at source is an important revenue gathering tool for the Government as it smoothens out cash flow crunches and also helps in planning the budget estimates of revenue inflows. The tax authorities are especially coming down very hard on a resident's failure to deduct tax at source on any sum, payable/paid to a non- resident, as once the non-resident leaves the country the tax authorities would have limited recourse to collect the tax. This is also the reason why there are enabling provisions in the Act to treat the resident as an agent of the non-resident to recover the short/non deduction of tax from the resident. The onus is placed on the resident while paying to a non-resident, to ensure that correct taxes have been withheld.

A non-resident would be liable to tax on all income accruing or arising in India, say for example–income from a trading activity within India or on the provision of a service or royalty or FTS.

If the income is taxable under the Act, the provisions of the DTAA, to the extent that they are more beneficial, can be resorted to minimize the tax liability. However, where no liability is imposed by the Act, the DTAA cannot fasten a liability as the DTAA does not have the right to charge income-tax.

As is evident from the above discussion, a non-resident would be liable to tax on certain incomes and therefore, in such cases the Payer would be obliged to withhold taxes. For instance, payments in the nature of Royalty for use or right to use any immovable property, payments in the nature of FTS, capital gains from transfer of Indian assets, payments in relation to PE of the non-resident, etc. Once it is established that the income is taxable and that the tax needs to be deducted therefrom, the next question would be at what rate tax is required to be deducted.

To summarize, the questions to be asked are:



In the answer to the last question also lies the answer to the current dispute between the taxpayer and the tax authorities. In order to attempt to answer that we shall examine the provisions of the Act which deal with withholding tax obligations on payments to a non-resident.

3.2.1 A look into Section 195

The relevant Chapter under the Act dealing with deduction of tax at source is Chapter XVII, Collection and Recovery of Tax. Section 195 of the Act contained therein, deals with provisions for deduction of tax at source on payments to be made to non-resident. Section 195 reads as under:

“195. (1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest referred to in section 194LB or section 194LC) [or section 194LD] or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries") shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force :

Provided that in the case of interest payable by the Government or a public sector bank within the meaning of clause (23D) of section 10 or a public financial institution within the meaning of that clause, deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode :

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Explanation 1.—For the purposes of this section, where any interest or other sum as aforesaid is credited to any account, whether called "Interest payable account" or "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly.

Explanation 2.—For the removal of doubts, it is hereby clarified that the obligation to comply with sub-section (1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident person has—

- (i) a residence or place of business or business connection in India; or*
- (ii) any other presence in any manner whatsoever in India.*

(2) Where the person responsible for paying any such sum chargeable under this Act (other than salary) to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he may make an application (in such form and manner to the Assessing Officer, to determine, in such manner as may be prescribed) the appropriate proportion of such sum so chargeable, and upon such determination, tax shall be deducted under sub-section (1) only on that proportion of the sum which is so chargeable.

(3) Subject to rules made under sub-section (5), any person entitled to receive any interest or other sum on which income-tax has to be deducted under sub-section (1) may make an application in the prescribed form to the Assessing Officer for the grant of a certificate authorising him to receive such interest or other sum without deduction of tax under that sub-section, and where any such certificate is granted, every person responsible for paying such interest or other sum to the person to whom such certificate is granted shall, so long as the certificate is in force, make payment of such interest or other sum without deducting tax thereon under sub-section (1).

(4) A certificate granted under sub-section (3) shall remain in force till the expiry of the period specified therein or, if it is cancelled by the Assessing Officer before the expiry of such period, till such cancellation.

(5) The Board may, having regard to the convenience of assesseees and the interests of revenue, by notification in the Official Gazette, make rules

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specifying the cases in which, and the circumstances under which, an application may be made for the grant of a certificate under sub-section (3) and the conditions subject to which such certificate may be granted and providing for all other matters connected therewith.

(6) The person responsible for paying to a non-resident, not being a company, or to a foreign company, any sum, whether or not chargeable under the provisions of this Act, shall furnish the information relating to payment of such sum, in such form and manner, as may be prescribed.

*(7) Notwithstanding anything contained in sub-section (1) and sub-section (2), the Board may, by notification in the Official Gazette, specify a class of persons or cases, where the person responsible for paying to a non-resident, not being a company, or to a foreign company, any sum, whether or not chargeable under the provisions of this Act, shall make an application (in such form and manner to the Assessing Officer, to determine, in such manner as may be prescribed) the appropriate proportion of sum chargeable, and upon such determination, tax shall be deducted under sub-section (1) on that proportion of the sum which is so chargeable.” **(Emphasis supplied)***

The provisions of section 195 have been elucidated in the subsequent paragraphs:

Sub-section (1)

It deals with a situation where the entire sum payable to a non-resident is chargeable to tax. Then the payer is obliged to deduct tax at source from the amount paid to the non-resident. The obligation to deduct tax at source arises at the time of credit of such payment to the account of the payee or at the time of payment thereof.

Explanation 1 states that where interest income or any other sum is credited to any account, by whatever name called, such amount shall be deemed to be credited to the account of the payee and the provisions of this section shall apply accordingly.

Explanation 2 has been inserted vide Finance Act, 2012 w.r.e.f 1-4-1962 to provide that every non-resident payer who is responsible for making any payment to non-resident (which is chargeable to tax in India) will have to comply with withholding tax requirements irrespective of the fact whether the non-resident has any presence in India or not.

Prior to insertion of Explanation 2, the general assumption was that since the Act does not clearly specify the applicability of the provision to non-resident

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payers, the term person as referred in section 195(1) should be interpreted as meaning 'resident' payers. Insertion of Explanation 2 clearly overturned the decision of Apex Court in the case of Vodafone International Holdings B.V. vs Union of India (2012) 17 taxmann 202 (SC). This has been touched upon in detail in the subsequent paragraphs.

Sub-section (2)

It deals with a situation where only a part of the sum payable to a non-resident is chargeable to tax. In that case, the payer may approach the Assessing Officer (AO) having jurisdiction over the non-resident to determine the quantum of sum chargeable to tax and the tax payable thereon. The application of section 195(2) pre-supposes that the person responsible for making the payment to the non-resident is in no doubt that tax is payable in respect of some part of the amount to be remitted to a non-resident but is not sure as to what should be the portion so taxable or is not sure as to the amount of tax to be deducted. In such a situation, he is required to make an application to the ITO (TDS) for determining, the appropriate proportion of such sum so chargeable, and upon such determination, tax shall be deducted under sub-section (1) only on that proportion of the sum which is so chargeable.

Sub-section (3), (4) & (5)

Sub-section (3) deals with the obligations of the recipient of the income. Where the non-resident in India is of the opinion that no tax will be payable by him, for the year, inter-alia on account of anticipated losses or on account of heavy accumulated losses he may approach the AO for a Certificate authorizing him to receive the income without deduction of tax at source. The procedure is prescribed in section 195(3) read with Rule 29B of the Rules. Rule 29B prescribes certain conditions to be fulfilled for making the said application. The Rule is inter alia, to ensure that the person making the application has a long standing presence in India and has not been deemed to be in default in respect of any tax, interest or penalty. Sub-section (4) provides that a certificate granted under section 195(3) shall remain in force till the expiry of the period specified therein or, if it is cancelled by the AO before such period, till such cancellation. Sub-section (5) states that the Board may make Rules specifying the cases in which and circumstances under which an application under section 195(3) shall be made. The non-resident is eligible to make an application under section 195(3) only if the

conditions laid down in Rule 29B are satisfied. The application in case of Banking Companies is to be made in Form 15C and in case of any other person, the application is to be made in Form 15D.

Sub-section 6

Until recently, in terms of provisions of section 195(6) of the Act, a person responsible for making payment [as referred in section 195(1) to a non-resident was required to furnish information in Form 15CA to the income-tax department. The form was required to be filed electronically with the tax authorities and a signed printout of it to be submitted to the authorised dealer, prior to remitting the payment to non-resident. Also, a certificate from an accountant was required to be obtained in Form 15CB before filing of Form 15CA.

The provisions of section 195(6) have been amended by Finance Act 2015 to provide that the person responsible for paying any sum, **whether chargeable to tax or not**, to a non-resident, not being a company, or to a foreign company, shall be required to furnish the information of the prescribed sum in such form and manner as may be prescribed⁵.

Sub-section 7

CBDT has been empowered by virtue of provisions of section 195(7) inserted by Finance Act, 2012 to notify a class of persons or cases to furnish an application to the AO to determine the appropriate proportion of sum chargeable, and upon such determination, the payer is liable to deduct tax under sub-section (1) on that proportion of the sum which is so chargeable. It may be noted that a Notification specifying such classes of persons or cases is not yet notified by CBDT.

3.2.2 Meaning of the term ‘chargeable to tax’

The expression “chargeable to tax” is the thrust of section 195. If a sum is not chargeable to tax under the Act, there would be no obligation to deduct tax at source. In case of incomes, which are undisputedly not chargeable to tax, the payer of the income may decide to not deduct tax at source. However, in case of sums payable where the taxability, or otherwise, is not so clear can the payer make a call on his obligation to deduct tax *suo moto*?

⁵ Rule 37BB and Form 15CA & 15CB (as amended vide Income Tax (21st Amendment) Rules, 2015)

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E.g. in case of a payment for the use of goods and/or services it would first be necessary to classify the income as royalty income or business income depending on the facts of the case. The next step would be deciding the rate at which tax has to be deducted at source. The taxpayer would seek to argue that the income is business income and not taxable in the absence of a PE whereas the tax authorities would like to classify it as royalty and bring it into the tax net.

The almost unanimous decision by the courts on this issue is that the payer of the income cannot make a *suo moto decision* on his own obligation. He must approach the AO to determine the extent of taxability. Please refer to the decision of the Supreme Court in the case of Transmission Corporation of A. P. Ltd. v. CIT [1991] 239 ITR 587 (SC). The courts have, on various occasions, held that in case of doubt on the portion of income taxable, of the amount to be paid to the non-resident, the payer must approach the tax officer to determine the tax liability. However, considering the amendment to section 40(a)(i) by the Finance Act 2004, with retrospective effect from 1 April, 2004, which prohibits deduction of payments made to non-residents, in arriving at the business income, unless tax has been deducted at source thereon, it would be safer to take a certificate from the AO.

In case of Samsung Electronics Company Ltd (2009) 320 ITR 209 (HC) , while dismissing various appeals filed by several software companies on the issue of liability to withhold tax on payments made to non-resident suppliers for readymade shrink wrapped software packages, the Karnataka High court had held that payments to non- resident tax payers which have an element of income per se, would require withholding of tax under section 195(1) of the Act. Further, if the payer is of the view that no taxes need to be withheld or taxes need to withheld at a rate lower than the prescribed rate under the Act, a prior approval of the AO, under section 195(2) of the Act is required specifying the rate (Nil/lower) at which tax ought to be withheld. This decision created a lot of uncertainty for residents as well as non-residents and the implications were far reaching causing taxpayers to review their withholding tax obligation and their respective policy in line with the decision. However, the decision has been over ruled by Honorable SC in case of GE India Technology Centre (p) Ltd v CIT 327 ITR 456 (SC) and cleared the dust with regard to the rights and obligations of a payer to withhold tax on payments to non-residents. The SC emphasized that withholding tax requirement would be triggered only if payments to non- resident constitute income chargeable

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to tax in India. If the payment is not in the nature of income, he cannot be held as an “assessee in default” for failure to withhold tax.

Further in case of Prasad Productions v ITO (2010) 129 TTJ 641 SB (CHN) and Van Oord ACZ India (P) Ltd v CIT 323 ITR 130 (HC) also it was held that that withholding tax obligation on payer under Section 195 of the Act applies only if the payments to non-residents are chargeable to tax in India.

The discussion on withholding provisions would be incomplete without discussing the landmark judgment of Vodafone International Holding v UOI 329 ITR 126 (HC) which had created a furor not only in India but also globally.

The facts of the case along with the key findings of the High Court as well as the Apex Court in the case of Vodafone Holdings are being discussed hereunder:-

The brief facts of the case are that:

- Vodafone International Holdings B.V (Vodafone), a Netherlands entity, had acquired 100 percent shares in CGP (Holdings) Limited (CGP), a Cayman Islands company for USD 11.2 billion from Hutchinson Telecommunications International Limited (HTIL).
- CGP, through various intermediate companies / contractual arrangements controlled 67 percent of Hutchison Essar Limited (HEL), an Indian entity. The acquisition resulted in Vodafone acquiring control over CGP and its downstream subsidiaries including, ultimately HEL.
- HEL was a joint venture between the Hutchinson group and the Essar group. It had obtained telecom licenses to provide cellular telephony in different circles in India from November 1994.
- The tax department issued a show cause notice to Vodafone to explain why tax was not withheld on payments made to HTIL in relation to the above transaction.
- Vodafone filed a writ petition in the Bombay High Court *inter alia* challenging the jurisdiction of the tax authorities in the matter.
- By its order dated 3 December 2008, the High Court held that the tax authorities had made out a strong (*prima facie*) case that the transaction was one of transfer of a capital asset situate in India.

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- Vodafone challenged the order of the Bombay High Court before the Supreme Court. In its ruling, the Supreme Court directed the Tax Authorities to determine the jurisdictional challenge raised by Vodafone. It also permitted Vodafone to challenge the decision of the tax authorities on the preliminary issue of jurisdiction before the High Court.
- The tax authorities held that they had jurisdiction to proceed against Vodafone for their failure to withhold tax from payments made under Section 201 of the Act. This Order of the tax authorities was challenged by Vodafone before the Bombay High Court.

The key findings of High Court were:

- The provisions of Section 195 of the Act can apply to a non-resident provided there is a sufficient territorial connection or nexus between him and India. Vodafone had, by virtue of diverse agreements entered into by it has nexus with Indian jurisdiction. Consequently, proceedings initiated under Section 201 of the Act for failure to withhold tax by Vodafone from payments made to HTIL in respect of the impugned transaction cannot be held to lack jurisdiction.
- The transaction was a composite one covering a complex web of arrangements and structure. Intrinsic to the transaction was a transfer of several rights and entitlement which would get covered with in the definition of capital asset under section 2 (14) of the Act. It would be simplistic to assume that the entire transaction was fulfilled merely upon the transfer of shares of CGP. The transfer of CGP shares alone would not have been sufficient to consummate the transaction. The transactional documents are not merely incidental or consequential to the transfer of the CGP share but recognize independently the rights and entitlements of HTIL in relation to the Indian business which was transferred to Vodafone.
- The consideration paid by Vodafone to HTIL was for the acquisition of various rights and entitlements. Under Section 5(2) the total income of a non-resident includes all income from whatever source derived which (a) is received or is deemed to be received in India or (b) accrues or arises or is deemed to accrue or arise to him in India. Section 9 explains the ambit of incomes which shall be deemed to accrue or arise in India. Where an asset or source of income is

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situated in India or where the capital asset is situated in India, all income which accrues or arises directly or indirectly through or from it shall be treated as income which is deemed to accrue or arise in India.

- It would be for the AO to apportion income which resulted to HTIL from the above transaction between income that has accrued or arisen (or deemed to have accrued or arisen) as a result of nexus within the Indian taxing jurisdiction and that which lies outside.

The High Court dismissed the petition by stating that the diverse rights and entitlements acquired by Vodafone had sufficient nexus with the territory of India for the tax authorities to initiate proceedings against Vodafone. Vodafone, subsequently appealed to the Supreme Court against this decision.

The Supreme Court held in favor of 'Vodafone' that since there was an offshore transaction between two non-resident companies and subject-matter of transaction was transfer of shares of CGP (another non-resident company), Indian tax authorities had no jurisdiction under section 9(1)(i) to tax said offshore transaction. This ruling of Apex Court had certainly settled the position that section 195 covers within its ambit only those non-resident payers who have a taxable presence in India.

Subsequent to the Supreme Court ruling in the case of Vodafone, multiple amendments were made in the law by Finance Act, 2012 w.r.e.f. 1-4-1962 to extend the provisions of taxation of non-residents in India. Amendments were made in the definition of 'transfer' in section 2(47) and the definition of 'capital asset' in section 2(14) of the Act to introduce taxation on indirect transfer of shares of an Indian Company by a non-resident to another non-resident. It was clarified in Section 9 of the Act that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India and the income from transfer of such shares would be deemed to accrue or arise in India. Explanation 2 to section 195(1) was inserted by Finance Act, 2012 w.r.e.f. 1-4-1962 to clarify that the obligation to comply with provisions of section 195(1) applies to all payers, whether residents or non-residents and irrespective of the fact that the non-resident person has a residence or a place of business or a business connection in India or any other presence in

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any manner in India. The decision of the Apex Court was thus overruled by amendment in the provisions of the Act.

Various situations and their consequences under section 195 of the Act are enumerated below:

S. No	Situation	Consequence
1	Bonafide belief on part of tax payer that no part of payment is chargeable.	No Taxes are Withheld
2	Payer's belief that whole of the payment is chargeable to tax.	Taxes are withheld
3	Payer's belief that only part of the payment is chargeable to tax.	Payer to file an application before the Tax Authority to determine tax withholding at appropriate rate and act accordingly.
4	Payer's belief that only part of the payment is chargeable to tax, but fails to make an application to tax authority.	Taxes are required to withheld on entire sum paid
5	Entire or part of the payment is income chargeable to tax, but fails to withhold any taxes	Payer treated as Assessee in-default and faces consequences for not withholding taxes such as tax recovery, interest, penalty prosecution, disallowance of expenditure. Payer is not treated as Assessee-in-Default, where the non-resident Payee files its return of income in India taking such income from the resident payer under consideration and paying the tax due on such income on its own account.
6	Belief of the payer that taxes have to be withheld, but recipient is of the	Recipient can make an application before the tax

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S. No	Situation	Consequence
	view that there should be no withholding of tax	authority for remittance without withholding any taxes or withholding taxes at a lower rate. If the recipient fails to obtain such certificate then he will receive the payment net of tax.

3.2.3 Rate at which tax is to be deducted

For the purpose of withholding tax provisions under section 195, 'the rates or rates in force' means the rate or rates of income tax specified in the Finance Act every year or the rates specified under the relevant DTAA's. While considering the rate at which tax has to be deducted at source on the payment to be made to the non-resident the provisions of the relevant DTAA must also be taken into consideration as, by virtue of provisions of section 90(2) the provisions of the DTAA will override the provisions of the Act to the extent they are more beneficial. This basic concept that the DTAA overrides Act to the extent it is more beneficial has been accepted and is enshrined in Circulars issued by the CBDT. Refer *Circular No. 728 dated 30th October 1995, [1995] 216 ITR (St)141, Circular No. 734 dated 24th January 1996, [1996] 217 ITR (St) 74, Circular No. 786 of 2000, [2000] 241 ITR (St) 132.*

Further, for the purpose of availing the beneficial rate under the tax treaties, section 90(4) requires the non-resident to hold a valid Tax Residency Certificate ('TRC') of the country of which he is a resident. The provisions of TRC under the Act are discussed briefly in the ensuing paragraphs.

3.2.4 Tax Residency Certificate

Tax Residency Certificate is one of the pre-requisites for the non-resident's entitlement to beneficial provisions of the DTAA. As per provisions of section 90(4), a non-resident shall not be entitled to claim any relief under the DTAA unless a certificate of his being resident of the country outside India is obtained from the Government of that country. Further, section 90(5) provides that the non-resident shall also provide such other documents and information as may be prescribed.

Rule 21AB has been notified by CBDT and the following information shall be furnished by the non-residents in prescribed Form 10F:

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- (i) Status of the non-resident
- (ii) Nationality or country or specified territory of incorporation
- (iii) Non-resident's tax identification number in the country and in case there is no such number, a unique number on the basis of which the non-resident is identified;
- (iv) Period for which residential status is applicable.
- (v) Address of the non-resident in the country of residence or

It has been clarified that additional information prescribed may not be required to be furnished if it already forms part of the TRC.

3.2.5 Withholding at a higher rate - Section 206AA

As discussed earlier, typically, tax is withheld as per the rates in force under the Act, or the treaty rates whichever is more beneficial to the assessee. However, Section 206AA requires tax withholding at a higher rate in certain specified situations (the deductee does not hold a valid PAN / other prescribed conditions). Thus, while considering the rate at which tax ought to be withheld the provisions of section 206AA would also have to be kept in mind.

The provisions of 206AA starts with a non obstante clause and are applicable to 'any person' entitled to receive any sum or income or amount, on which tax is deductible under Chapter XVII. The language of the provision did not carve out any exception for any specific class of persons and an ambiguity arose as regards its applicability to non-residents at the time when provisions were introduced. Subsequently, a press release was issued by CBDT clarifying that the rigors of section 206AA would equally apply to payment to non-residents.

Section 206AA provides that it would be mandatory for recipient of income, on which tax is deductible at source, to furnish his Permanent Account Number (PAN) to the person responsible for deducting the tax, failing which tax shall be deducted at the higher of the following rates:-

- (i) at the rate specified in the relevant provision of the Act;
- (ii) at the rate or rates in force; or
- (iii) at the rate of twenty percent.

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Further, Section 206AA has been recently amended by Finance Act, 2016 to provide that provisions of this section shall not apply in respect of:

- payment of interest on long-term bonds referred to u/s 194LC
- other payments on fulfillment of such conditions as may be prescribed.

Notification No 53/2016 dated 24th June 2016 has been issued by CBDT to provide that provisions of section 206AA shall not be applicable in case of payments made to non-residents, not being a company or a foreign company and not having PAN. The payments specified to such non-residents are interest, royalty, fees for technical services and payments on transfer of any capital asset.

The following details and documents shall be furnished by the non-residents:-

- (i) name, email id, contact number;
- (ii) address in the country or specified territory outside India of which such non-resident deductee is a resident
- (iii) certificate of residence of the country or specified territory if the laws of such country/specified territory provides for issuance of such certificate.
- (iv) Tax Identification Number or if no such number is available, unique number on the basis of which the non-resident deductee is identified by the Government of that country/specified territory.

Whether 206AA overrides the treaty rates

There are conflicting views as regards the rate of tax deduction to be adopted for the purpose of section 206AA from payments made to the non-residents when the beneficial provisions of the Treaty are available. The first view opines that section 206AA is a machinery provision which has to be read along with the charging provisions and computation mechanism as provided in the Act. Irrespective of the provision having a 'non-obstante' clause, the same could not be read in severance of and independent of the charging and computation provisions.

The second view, on the other hand, opines that Section 206AA is a machinery provision, which deals with deduction of tax at higher rates, in case of a recipient not furnishing the PAN. It only results in higher

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withholding and not higher taxation. The final tax liability of the non-resident is not in any way altered by the provisions of section 206AA.

3.2.6 Withholding tax provisions in respect of Specified payments

Payments in respect of salaries

In case of salaries payable to a non-resident rendering service in India the requirement of deduction of tax at source is governed by the provisions of section 192 and not section 195. The intricacies and complications involved in determination of the taxability and the extent of the taxability are discussed in detail in Chapter 5 under 'Dependent Personnel Services'.

Payments in respect of income of offshore Funds/FIIs

Income from units purchased in foreign currency by an offshore fund are governed by the provisions of section 196B and there is requirement to deduct tax at source at the rate of 10 per cent in respect of income arising from units or long term capital gains arising on the transfer of such units which are liable to tax.

Payments in respect of interest income or dividends in respect of bonds or Global Depository Receipts ('GDR') or, by way of long term capital gains arising on transfer thereof are governed by the provisions of section 196C of the Act and require tax to be deducted at source at ten percent.

Payments in respect income from securities in the case of FIIs are governed by the provisions of section 196D and require tax to be deducted at source at the rate of twenty percent.

The applicability of the provisions of the securities transaction tax also have to be considered as, if the capital gains are exempt no tax is deductible thereon.**Payment for royalty/FTS**

The withholding of taxes on payments in the nature of Royalty / FTS would be governed in line with the taxability of such payments in the hands of the recipient. The taxability of these payments has already been discussed in detail in the earlier portion.

3.2.7 Credit for tax deducted at source

As per section 198 of the Act tax deducted at source is considered as income of the recipient of the income. As per section 199 of the Act credit is allowed

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in respect of the tax deducted on production of the Certificate issued by the person responsible for deducting tax.

3.2.8 Consequences of Non-deduction of Tax at Source from Payments to non-resident

In cases where an assessee has paid any sum chargeable to tax under the Act to a non-resident on which tax has not been deducted under section 195 or after deduction has not deposited the same with the exchequer, the assessee shall be liable for the following consequences:

Sr. No	Section	Nature of Default	Consequence
1	40 (a)	Failure to deduct the whole or any part of the tax	Disallowance of expenses in computation of business income if assessee considered as assessee in default.
2	201(1A)	Failure to (i) deduct; (ii) pay; or (iii) pay after deducting	Considered an assessee in default subject to interest of 1% or 1.5% p.m. However, assessee shall not be considered as assessee in default, where the non-resident payee submits return of income in India taking into consideration the income received from the assessee and deposits tax on such income.
3	221	Default in payment of tax	Penalty not exceeding amount of tax in arrears
4	271C	Failure to deduct tax or pay the whole or part of tax	Penalty of an amount equivalent to the tax failed to deduct or pay
5	271H	Failure to furnish TDS return/furnish incorrect information	Penalty of an amount not exceeding Rs 10,000 but which may extend to Rs 1 lac
6	271-I	Failure to furnish /furnishing incorrect information u/s 195(6)	Penalty of a sum of Rs 1 lac

3.3 Treaty shopping

3.3.1 Treaty overrides the Act

The Executive has been given rights under Article 73 of the Constitution to enter into DTAA's. This is an executive power, which is also a part of the governmental function after legislative and judicial functions. As the power to enter into DTAA's comes from the Constitution, Article 73 will have the effect of the DTAA overriding the Act, as the Executive also has to exercise jurisdiction keeping in mind DTAA obligations and commitments made. Also, section 90(2) of the Act clearly lays down that where the treaty exists, provisions of the Act shall apply to the extent they are more beneficial than the treaty. The proposition that DTAA overrides the Act is undisputed now by all. Refer *CIT v. Davy Ashmore India Ltd* [1991] 190 ITR 626 (Cal); *CIT v. R M Muthiah* [1993] 202 ITR 508 (Kar); *CIT, v. R. S. R. M. Firm* [1994] 208 ITR 400 (Mad); *Arabian Express Lines Ltd* 401 [1995] 212 ITR 31 (Guj); *CIT v. Visakhapatnam Port Trust* [1983] 144 ITR 146 (AP).

Therefore, if a taxpayer has legitimately reduced his tax burden by taking advantage of a treaty the benefit cannot be denied to him on the ground of loss of revenue. This matter was also settled by the landmark decision of the Supreme Court in the case of *Azadi Bachao Andolan*⁶. The rationale behind this is, as said earlier, that Treaties are signed not only considering the tax implications but also political implications, the Government of both the States are well aware of the law at the time of signing the Treaty e.g. the fact that certain incomes are not taxed in certain countries ought to have been a fact well known, therefore, to deny treaty benefits on the ground that no tax has been paid in the country of source defeats the purpose of the DTAA.

3.3.2 Treaty shopping and tax havens

Treaty Shopping

Just as the domestic law can be used sometimes more than fairly to the advantage of a taxpayer, the DTAA too is exploited. This is popularly known as "Treaty Shopping". The use of a tax treaty by a person who is not a resident in either of the treaty countries (usually through the use of a conduit entity resident in one of the countries) to minimize tax costs is known as treaty shopping.

⁶ *Azadi Bachao Andolan v UOI* (2003) 263 ITR 706 (SC)

A non-resident seeking shelter under a DTAA is still open to domestic assessment if the tax authorities feel that he is taking a wrong advantage of provisions of the DTAA or has structured the agreement in such a way so as avail the DTAA benefits which are not otherwise available to him. The tax authorities may deny the benefits of the DTAA.

Tax Havens / Off-shore Companies

There are expressions like “tax havens”, “offshore companies” and “offshore funds” in the field of international taxation. These tax havens attract investments as the rate of tax on corporate profits is low and generally exempt dividends and capital gains on alienation of movable assets like shares and sometimes immovable property also.

The term “offshore” is derived from holding the assets and investments outside the home country. These offshore centers and tax havens are unique in not only tax advantages, but their often “no questions asked” policy and secrecy norms, and easy exchange control norms besides tax. These are also factors that attract capital. Though of course here, what is sauce for the Goose is poison for the gander as dealing with offshore companies in tax havens is a nightmare for the revenue authorities. These ‘tax havens’ encourage tax planning which borders on tax evasion and are generally reluctant to exchange information about shell companies.

Treaty havens permit conduit flow-through companies to be set up. These conduit companies work by eroding their tax base by either expatriating profits or transferring them to another form in the form of tax deductible expenses. The most popular use of tax havens is for sale of royalty and Intellectual Property Rights (IPR). These are transferred to a tax haven company (at the time of transfer the IPR would not have gathered a significant commercial value and it is also essential that subsequent sale should be tax neutral). The rate of tax on royalty is also generally low in these tax havens. The conduit company will allow use of the IPR. The royalty received will not be subject to withholding taxes based on local laws and DTAA's entered into by the tax havens. The profits will then be routed back to the main company. In fact, it is also possible that the funds are allowed to accumulate in the tax haven and will be used to finance other capital projects or acquisitions.

Litigation on the issue

The most litigation is centered on treaty shopping and tax havens. The

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decision of the Supreme Court in the case of *Azadi Bachao Andolan* referred to earlier has held that Treaty Shopping is legitimate when it is done within the boundaries of the law. In the case of *Mc Dowell & Co Ltd vs CTO* (1985) 22 taxmann 11 (SC) also, the Supreme Court held that “*the tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.*”

Following the decision of the Supreme Court in *Azadi Bachao Andolan* the Authority for Advance Ruling (AAR) in case of *E-Trade Mauritius Ltd* (2010) 324 ITR 1 (AAR), the AAR, observed that if a resident of a third country seeks to take advantage of the tax relief and economic benefits under any tax treaty through a conduit entity, the legal transactions entered into by that conduit entity cannot be declared invalid. The design of tax avoidance by itself is not objectionable if it is within the framework of law and not prohibited by law. In the case of *Ardex Investments Mauritius Ltd* (2011) 16 taxmann.com 84 (AAR), while holding that capital gains was not chargeable to tax in India in view of article 13.4 of the India-Mauritius Tax Treaty, the AAR placed reliance on the Supreme Court decision of *Azadi Bachao* (*supra*)

The Supreme Court in the case of *Vodafone* (*supra*) elucidated as to in what circumstances the corporate veil can be pierced and a ‘look through’ approach instead of a ‘look at’ approach can be adopted. The SC *inter-alia* observed that “*The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device*”. The SC also held that the onus is on the revenue to disprove the commercial substance and establish abuse. Further, this should be done at the threshold and not by adopting a dissecting approach.

As we shall see with a few examples in Chapter 5 dealing with specific DTAA Articles the most common form of Treaty Shopping is setting up of a dummy enterprise. This dummy enterprise would be set up by say, Company A, in one of the Contracting States, to avail DTAA benefits which, Company A, and not being a resident of either Contracting States would otherwise not be entitled to. In such circumstances, the Courts can pierce the corporate veil.

Here, it is important to understand a subtle distinction between, using a Treaty to an advantage and Treaty Shopping. If a benefit conferred by the treaty is used, just because it may result in non-payment of taxes in both countries, does not and cannot nullify a transaction. The Treaty has to be interpreted as it is.

However, where a conduit operation is suspected, then piercing the corporate veil can be justified. It is always the substance and not the form which will prevail.

Each case will have its own factual peculiarities and structural merits which will have to be given due cognizance to in order to determine if lifting the corporate veil is warranted.

3.3.3 Tackling treaty shopping

Various countries have evolved rules in their domestic and DTAA law to tackle tax evasion, e.g. the ability to compute and adopt an arm's length price in respect of related transaction, or the courts going into the substance over form of the transaction to sniff out tax evasion.

Recently, the MLI has introduced the concept of 'Principal Purpose Test' as a minimum standard to be adopted by all the countries opting for the MLI. Treaty shopping can be tackled by enabling DTAA provisions with mechanisms to make routing transaction through sham companies more difficult by including provisions which make some activity necessary in a country beyond the scope of registration.

For e.g. the India- Singapore DTAA⁷ has a "Limitation of Benefits" clause. The Limitation of Benefits (LOB) is meant to prevent abuse of the above capital gains tax exemption. The LOB provision provides as follows:

- Tax resident will not be entitled to the capital gains tax exemption if its affairs are arranged primarily to take advantage of the benefits of the capital gains tax exemption.
- A shell/conduit company (i.e. A company being a resident of a Contracting State with negligible or nil business operations or with no real and continuous business activities in the Resident State) will not be eligible for the capital gains tax exemption.

⁷ Amended vide Third Protocol to the tax treaty– Refer Notification No. SO 935(E), dated 23.03.2017

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- A company is considered to not be a shell company if:
- It is listed on a recognized stock exchange; or
- Its total annual expenditure or operation in Singapore is equal to or more than S\$ 200,000 or INR 50,00,000 as the case may be, in immediately preceding period of 24 months from the date of gain arises i.e. the date of sale.
- Further, to put a check on the so called tax heavenly Mauritius, the India Mauritius tax treaty was amended vide protocol⁸ in August 2016. The highlights of the key changes are as under:
- Source-based taxation on capital gains arising from the alienation of shares acquired on or after 1 April 2017 in a company resident in India with effect from FY 2017-18.
- In respect of capital gains arising during the transition period from 1 April 2017 to 31 March 2019, the tax rate will be limited to 50% of the applicable domestic tax rate in India, subject to fulfillment of the conditions in the LOB Article. Taxation in India at a full domestic tax rate will take place from 1 April 2019 onwards (i.e. FY 2019-20).
- A Mauritius resident (including a shell / conduit company) shall not be entitled to benefits of 50% reduction in tax rate, if it fails the main purpose test and bonafide business test.

A resident is deemed to be a shell/ conduit company, if its total expenditure on operations in Mauritius is less than Mauritian Rs. 1,500,000 or Indian Rs. 2,700,000 in the immediately preceding 12 months.

Similarly, in order to prevent the treaty shopping practice, India Cyprus treaty was also amended⁹ to provide for source based taxation of capital gains arising from alienation of shares that have been acquired on or after 1 April 2017.

However, treaty abuse can only be seriously tackled when some countries stop encouraging and when local laws are not as disparate as they are now. In fact the MAP and Exchange of Information Articles also provide

⁸ Refer Notification No. SO 2680(E) {No.68/2016 (F.No.500/3/2012-FTD-ii)}, dated 10-8-2016

⁹ Vide Notification No. SO 64(E) [NO.3/2017 (F.NO.504/05/2003-FTD-I)], DATED 10-1-2017

Taxation of Non-Residents

Contracting States to collect information to tackle treaty shopping. The government has started re-negotiating the tax treaties in order to facilitate the exchange of information on tax matters. India, currently has DTAA's with 95 countries and DTAA's. In case of those countries, where India is not in a position to expeditiously enter into a DTAA, usually TIEA's (Tax Information Exchange Agreements) are entered (which have provisions only for exchange of Information). Currently, India has entered into 20 TIEA's. Recently, India was amongst the initial 68 countries who signed for MLI on 7 June 2017. Thereafter, on 25 June 2019, India deposited its instrument of ratification with the OECD conveying its final position on MLI provisions to implement tax treaty related measures for preventing BEPS. The MLI provisions have come into force for India on 1 October 2019, and are already into effect from 01 April 2020, to certain extent.

India has notified treaties with 93 countries to be covered by MLI provisions. As on date, about 47 countries (other than India) have deposited their instrument of ratification with the OECD. So, India's tax treaties with these countries are already subject to, or would be subject to, MLI provisions based on the position adopted by respective country on applicability of MLI provisions. For remaining countries, MLI provisions would come into effect soon after their depositing of instrument of ratification with OECD.

Not only the treaties are being re-negotiated to include anti-abuse measures or for facilitation of exchange of information, the Anti-Avoidance Rules (GAAR) has also been brought in under the Act to repress the aggressive tax planning strategies. Until now, the GAAR existed in terms of principles emanating from judicial precedents. But now, the GAAR has been introduced under the Act itself under Chapter X-A and w.e.f. FY 2017-18. The provisions are applicable to any arrangement entered into by an assessee declared as impermissible avoidance arrangement. It may also be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement. It is important to note that if an arrangement is trampled with GAAR, the beneficial provisions of the treaty shall not apply.

One of the concerns often expressed even in discussions at OECD is the concern of treaty shopping or improper use of treaty conventions. In 2003, the OECD added the following guiding principle to the commentary on Article 1:

...the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable

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treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

The OECD has also been providing solutions to tackle aggressive tax planning over the years. The concept of Base Erosion and Profit Shifting (BEPS) is also a reflection of one such solution. BEPS refers to tax planning strategies that exploit gaps and mis-matches in tax rules to artificially shift profits to low or no tax locations resulting in nil or zilch corporate tax being paid. 15 Action Plans are being set forth to combat BEPS in a comprehensive and coordinated way.

BEPS Action Plan 6 titled - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances deals with a variety of measures to control treaty abuse. BEPS Action 6 provides the following reasoning for formulation of stricter norms of treaty abuse, further the report indicates that while there are examples in Commentary on Article 1 to prevent treaty shopping, stricter anti-abuse will contribute to restore source taxation.

“Current rules work well in many cases, but they need to be adapted to prevent BEPS that results from the interactions among more than two countries and to fully account for global value chains...FDI figures show the magnitude of the use of certain regimes to channel investments and intra-group financing from one country to another through conduit structures. In order to preserve the intended effects of bilateral relationships, the rules must be modified to address the use of multiple layers of legal entities inserted between the residence country and the source country.”

BEPS action plan are discussed in a greater detail in a subsequent Chapter. Treaty Shopping must be checked because ultimately in a Treaty one country is sacrificing its right to tax the income in favor of another country. That the benefit should go to an un-intended third country is therefore not fair. Though the resident country may ultimately get to tax the profits on repatriation there is a deferment of collection of revenue which may be a complete loss if the profits are not ultimately repatriated.

3.4 Other relevant provisions for taxation non-residents / Foreign Companies

3.4.1 MAT on Foreign Companies

Applicability of MAT provisions in case of foreign companies had been a subject matter of litigation for long. Finance Act 2015 inserted new clause

(fb) and (iid) to Explanation 1 wherein adjustments were provided with respect to the capital gains from securities and interest, royalty and FTS. These provisions were made applicable w.e.f. 1-4-2016. This resulted in an ambiguity as to whether MAT provisions were implicitly applicable on foreign companies even prior to the amendment by Finance Act 2015. To this effect, Finance Bill 2016 clarified that the MAT provisions shall not be applicable to a foreign company w.r.e.f 1-4-01 subject to fulfillment of following conditions:

- The foreign company is a resident of country with which India has a DTAA and the foreign company does not have a PE in India in accordance with the provisions of such DTAA.
- The foreign company is a resident of a country with which India does not have a DTAA and the foreign company is not required to be registered under any law for the time being in force relating to the companies.
- Subsequently, Explanation 4A was added by Finance Act 2018, w.r.e.f. 1.4.01 which clarified that MAT provisions are not applicable to a foreign company where its total income comprises only of profits taxable on presumptive basis under section 44B or 44BB , 44BBA, 44BBB.

3.4.2 Equalisation Levy

The Memorandum to Finance Bill, 2016 reports that the digital economy is growing at a very fast pace. Considering the potential of new digital economy and the rapidly evolving nature of business operations, it is found essential to address the challenges in terms of taxation of such digital transactions. To this effect, the Finance Act, 2016 has introduced Equalisation Levy under Chapter VIII.

Equalization Levy is chargeable @ 6% of the amount of consideration for any specified service receivable by a non-resident from:

- A person resident in India and carrying on business or profession; or
- A non-resident having a PE in India.

It is also provided that Equalisation Levy shall not be charged when:

- The non-resident providing the specified services has a PE in India and the specified services are effectively connected with such PE; or

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- Where the payment for specified services does not exceed one lakh rupees; or
- Where the payment for specified services is not for the purposes of carrying on business or profession.

Specified services have been defined to include online advertisement, provision of digital advertising space or any other facility of service for the purpose of online advertisement.

Section 10(50) of the Act provides an exemption from taxation w.r.t. the income which has been subjected to Equalisation Levy.

Expansion of Scope of Equalisation Levy

Government of India, vide Finance Act, 2020 has expanded the scope of equalisation levy and has introduced a new section 165A in the Finance Act 2016.

As per the said section, an e-commerce operator shall be liable to charge equalisation levy at the rate of two per cent of the amount of consideration received or receivable from e-commerce supply or services made or provided or facilitated by it to the following persons:

- to a person resident in India; or
- to a non-resident in specified circumstances. i.e. sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement through internet protocol address located in India; and sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India
- to a person who buys such goods or services or both using internet protocol address located in India.

Specified Transactions

E-commerce supply or services means

- online sale of goods owned by the e-commerce operator;
- online provision of services provided by the e-commerce operator; or
- online sale of goods or provision of services or both, facilitated by the e-commerce operator; or
- any combination of activities listed in clause (i), (ii) or clause (iii)

E-commerce operator

E-commerce operator means a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both.

Exclusions

The equalisation levy shall not be charged where :

- the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment.
- the equalisation levy is leviable under section 165 of Finance Act 2016
- sales, turnover or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated is less than two crore rupees during the previous year

Payment of Equalisation Levy

The equalisation levy referred to section 165A above, shall be paid by every e-commerce operator to the credit of the Central Government as under:

Date of ending of the quarter of financial year	Due date of payment
30 th June	7 th July
30 th September	7 th October
31 st December	7 th January
31 st March	31 st March

3.4.3 Return Filing Obligations

The obligation to file return of income in India arises by virtue of provisions of section 139 of the Act which casts a duty on:

- a) every person, being a company or a firm; or
- b) a person other than a company or a firm having total income exceeding the maximum amount chargeable to tax during the previous year

to file the return of income in the prescribed form and manner.

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In cases where the income is not chargeable to tax both under the provisions of the Act as well as under the provisions of the DTAA, there would be no obligation to file the return of income. Similarly, in cases where income is chargeable both under the provisions of the Act as well as DTAA, the foreign company is liable to file the return of income in India.

However, in cases where the income is chargeable to tax under the provisions of the Act, but is not chargeable by virtue of beneficial provisions of the DTAA (for e.g. make available condition in FTS), the judicial view on obligation to file return of income seems to be divided. One view holds that once there is chargeability to tax under the Act, the return of income will have to be filed under section 139, even if the benefit of the DTAA is claimed or a ruling is given on that basis. The other view holds that in absence of any taxable income of the entity the liability to pay tax rests upon sections 4 and 5, which are the charging sections. Section 139 and other sections are merely machinery sections to determine the amount of tax. There would be no occasion to call a machinery section in aid where there is no liability at all.

Another aspect which merits attention is that where it is not necessary for the non-resident to furnish return of income u/s 139 (1), the Statute has specifically provided for non-residents earning income in the nature of only interest, dividends, royalty and FTS as exempt from the requirement of furnishing of return of income. For instance, a non-resident is absolved from furnishing return of income by virtue of provision of section 115AC (4) if the income of the non-resident comprises of interest and dividend income only and tax has been deducted. Further, it has also been held by the Apex Court in the case of GE India (supra) that the withholding tax requirement would be triggered only if payments to non- resident constitute income chargeable to tax in India. Thus, even the chargeability to tax is a precondition for withholding tax provisions.

Finance Act, 2017 has inserted a new section 234F which provides for a fee for delay in furnishing the return of income beyond the time limit prescribed under section 139(1) of the Act. The levy of such fee is automatic and ranges as below:

- If the Return Is furnished before 31st December of the assessment year - a sum of five thousand rupees;
- In any other case – a sum of ten thousand rupees;
- However, if the total income does not exceed five lakh rupees, the fee payable under this section shall not exceed one thousand rupees.

Further, as per the provisions of section 276CC of the Act, The Revenue Authorities may initiate prosecution proceedings in relation to non-filing of Return of Income.

One needs to be mindful of the aforesaid consequences attached to non-filing of Return of Income.

Requirement to obtain PAN - The net widened

In order to furnish return of income, every person is required to obtain a permanent account number (PAN) as a mandatory compliance requirement. Section 139A casts an obligation on every person to obtain PAN in certain specified situations which inter-alia includes the situation where the total income of a person exceeds the maximum amount not chargeable to tax. This section was amended by Finance Act, 2018 to extend the requirement to obtain a PAN to the following persons:

- (a) a resident, not being an individual, entering into a financial transaction aggregating to two lakh fifty thousand rupees or more in a financial year;
- (b) managing director, director, partner, trustee, author, founder, karta, chief executive officer, principal officer or office bearer of such resident person or any person competent to act on behalf of such resident person as mentioned above.

Pursuant to this amendment, all individuals/non-individuals (irrespective of whether they are resident or non-resident persons), shall be required to apply for PAN, in case of their connection with a resident which has entered into financial transaction as specified.

4

DOUBLE TAXATION

4.1 Concept of double taxation

While the globe converges into one big market place for purchase and sale of a variety of goods and services, each jurisdiction fights to tighten its rope to grab its share of taxes. This more often than not creates a situation where one single source of income may get taxed twice over in different jurisdictions based on taxation laws of the respective countries.

¹International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods & services and movements of capital, technology and persons, are so well known that it is hardly needed to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

Elimination of double taxation thus becomes essential for international trade to flourish. Though tax structures do not drive business decisions, they definitely poses significant influence over investment decisions in any jurisdiction.

4.2 Circumstances that give rise to “Double Taxation”

- International Juridical double taxation mainly arises because of various states, in addition to levying taxes on income sourced in its jurisdiction (**source rule**), also seek to levy tax on incomes / capital arising from transaction carried in other countries by its resident taxpayers (**residence rule**). Eg.: If an US entity lends money to Indian Company, then interest income earned by the US entity will be chargeable to tax in India since income is sourced in India. Similarly the US entity, would be subject to tax on its world-wide income in the US based on it being resident of USA. This gives rise to double taxation.

¹ Extract from Introduction to the OECD Model

- When a person is considered as Resident in two or more states simultaneously, double taxation of same income may arise. E.g. In cases where one person is deemed to be resident by virtue of POEM² situated in Country X, while naturally he is also resident in Country Y.
- When source rules overlap, double taxation may arise. i.e. where two or more countries as per their domestic laws conclude that in respect of the same transaction, income arises or is deemed to arise in both their respective jurisdictions.
- 'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different taxpayers (because of lack of subject identity). Eg. When one state attributes an income/capital to its legal owner whereas the tax law of other state attributes it in the hands of the person in possession or having economic control over the income. Yet another classic example is tax on distributed surplus by a company which is taxed in the hands of the company distributing such surplus, while the other jurisdiction taxes the said income from distribution in the hands of the shareholder.

4.3 The Concept of Tax Neutrality

Generally the tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons. In some cases, neutrality is impossible and policymakers have to accept a certain level of distortion to behavior as inevitable. In other cases, neutrality may be undesirable if policymakers intend to promote the specific goals

In the international context, the concept of tax neutrality has several standards. These are:

- Capital export Neutrality
- Capital-Import neutrality or Foreign Competitive Neutrality
- National Neutrality

Each of these standards is explained in brief below.

² POEM- place of effective management

4.3.1 Capital export neutrality

This standard is fulfilled if the taxpayer's choice of investment (i.e. whether to invest in his home country or to invest overseas) is not influenced by taxation. In other words, the tax consequences are the same whether the taxpayer invests in his home country or abroad. This would result in an efficient allocation of capital and the decision to invest would depend upon business considerations rather than upon tax rates. This can be achieved if the home country, either by unilateral action, or by bilateral agreements, ensures that the taxpayer will not pay more taxes if he invests abroad. Capital export neutrality seeks to support either a purely residence-based system or worldwide source-based taxation with an unlimited foreign tax credit. For example, if an Indian company invests abroad say in the USA and the USA taxes the income on a 'source' basis. India will obviously tax the said income on the principle of residence. So, if the elimination of double taxation was not present in the India-USA DTAA, the Indian company would have to pay taxes in both India and the USA. But, because India would allow credit for taxes paid by the company in USA, the transaction becomes capital-export neutral (subject to certain conditions) for the Indian company as it pays on an overall basis, the same tax as it would have paid had it invested in India.

4.3.2 Capital import neutrality

The concept of capital-import neutrality or foreign competitive neutrality envisages that all the enterprises investing in a country pay taxes at a similar rate. It requires that all investments in a given country pay the same marginal rate of tax regardless of the residence of the investor. This means that all business activity within a country is subject to the same over- all level of taxation. If capital import neutrality holds, all savers receive the same after-tax return, regardless of their residence. Capital import neutrality is believed to support taxation by the source country along with the residence country exempting foreign source income. For example, if a company incorporated in the USA was to invest in India, India would tax the said income on a 'source' basis. If under the treaty, the USA would exempt the income that was taxed in India, from tax in its own jurisdiction, it would achieve what is known as capital-import neutrality. Unfortunately, the exemption method would not achieve capital- export neutrality if the tax rate were to be lower in India as compared to that in the USA. The difference between the exemption method and the credit method is that the exemption method seeks to distribute the

subject matter of taxation (i.e. the income) between the two jurisdictions whereas the credit method divides the tax itself.

4.3.3 National neutrality

This neutrality is sought to be achieved by allowing the tax paid in the foreign country as a deduction from the income when the same income is taxed in the home country. In other words, foreign tax paid is allowed as business expenditure in line with other non-income taxes such as sales tax, excise duty, octroi duty etc. This method is popularly called the 'deduction method' but is generally seldom used internationally.

Most countries follow a combination of the exemption method, the credit method and the deduction method to allow relief from double taxation method. A few countries however have certain very interesting variations. For example, Belgium follows what can be called a 'reduction' method. Under this method, income earned abroad is taxed at a concessional rate. Another method that attracts attention to international investors is the method followed in the Netherlands. The Netherlands at the first stage, applies the worldwide test of unlimited liability computing tax on income from foreign and domestic sources. Then, if income from a foreign PE has suffered tax abroad, the total tax due in Netherlands is reduced in the same proportion that the foreign income bears to the total income. In other words, the Netherlands sourced income is taxed at the progressive rate applicable to the total income and the progressive nature of the income-tax is not impaired. This, in Indian terminology, is giving credit at the 'average rate of tax'. This method is useful only where the income is taxed at varying progressive rates.

4.4 Methods of avoiding double taxation

4.4.1 Tax Treaties (Bilateral relief)

Double Taxation Avoidance Agreement (DTAA) also referred as Tax Treaty is a bilateral economic agreement between two nations that aims to avoid or eliminate double taxation of the same income in two countries. The basic objective is to promote and foster economic trade and investment between two Countries by avoiding double taxation.

Trade has now become global with goods and services seeking the best buyer and seller. To encourage trade and free movement of goods and capital, countries sign DTAA's. These DTAA's along with bolstering trade

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between nations also help in ensuring that a person is not burdened with taxes twice over on the same income. However, it may so happen that there may be no DTAA with a country; in that case the Act provides for unilateral relief under section 91 as discussed below

4.4.2 Unilateral Relief

Section 91 operates at two levels; sub-section (1) deals with the case of a resident who has earned income in a foreign country with which India has no DTAA. It is upto the resident to prove that the income did not accrue or arise in India but only in the foreign country and that tax has been paid thereon. If these conditions are met, the resident is allowed a deduction from the tax payable on the total income. The deduction is computed by applying the Indian rate of tax and the foreign rate of tax to such doubly taxed income and is restricted to the lower of the results of such taxes. If both the rates of tax are equal the Indian rate of tax is to be considered. The Indian rate of tax means the rate determined by dividing the amount of Indian income after all deductions/reliefs except this section by the total income. The foreign rate of tax means the total tax paid abroad divided by the income earned abroad. Section 91(2) deals with income earned in Pakistan operates on almost similar lines as section 91(1).

Section 91(3) deals with the case of a non-resident who is assessed in India, whose share in the income of an Indian partnership includes income which has been earned income in a foreign country with which India has no DTAA and on which tax has been paid; he will be entitled to a deduction from such income for the tax paid in the foreign country and such deduction will be computed in the same manner as in the case of a resident described above.

Section 91 being a provision extending relief, requires that tax should have been actually paid. Pursuantly, no relief is available if no tax has been paid. This is also the distinction drawn by the Supreme Court in the case of ³*CIT v. Carew & Co. Ltd. [1979] 120 ITR 540*.

The expression 'such doubly taxed income' contained in the section indicates that it is only that portion of the income on which tax has in fact been imposed and been paid by the taxpayer that is eligible for double tax relief.

Is the doubly taxed income to be considered with reference to the total

³ This case was in reference to s.49D of Income Tax Act, 1922

income or only against that income which has been doubly taxed was an issue, however the Supreme Court in the case of *Azadi Bachao Andolan*⁴ has laid down the principle that it is not necessary that avoidance of double taxation can arise only when tax is actually paid in one Contracting State. In fact, the Supreme Court in an earlier decision in the case of *KVALM. M. Ramanathan Chettiar v. CIT [1973] 88 ITR 169* also, held that the Act contemplates taxation of total income, though that income may be determined under different heads, the foreign income has to be included in the total income in India, the word “such” in the phrase “such doubly taxed income” refers to this foreign income which is again subjected to tax by being included in the total income. Income tax should be considered as leviable on such total income.

Thus, the Act vide provisions of section 90 ensures that where a DTAA is in existence, the taxpayer is not made to suffer double taxation, by a provision in the DTAA and where a DTAA is not in existence, the taxpayer is not made to suffer double taxation by giving a relief under section 91 of the Act in respect of the doubly taxed income.

In an interesting ruling in the case of *DCIT vs Tata Sons Limited*⁵, the Mumbai bench of the Tribunal held that the US federal tax and state tax paid in respect of income earned overseas are not deductible as expenditure incurred for earning income under section 37 of the Act. Tribunal further observed that though relief is not available for state income taxes paid under the India- US DTAA, the relief is available under Section 91 read with Section 90 of the Act.

This is an important ruling from the Mumbai Tribunal, where it has been held that foreign taxes (including state tax) paid by the taxpayer are covered by Section 40(a)(ii) of the Act and therefore, not deductible as expenditure while computing taxable income under the Act. This decision was rendered in the context of India-USA DTAA, in terms of which only federal taxes paid in US are eligible for credit in India. The Tribunal also held that state taxes paid in US, which are not eligible for credit under the tax treaty, would be entitled to relief under Section 91 of the Act.

Relief under section 91(1) of the Act, is to be computed on country wise

⁴ (2003) 263 ITR 706 (SC)

⁵ (ITA No. 4776/ Mum/ 04)

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basis and not on basis of aggregation of income of all foreign countries. Where such relief is by way of the credit system, it is the lesser of the two taxes on the doubly taxed income. Where the taxpayer is entitled to relief in respect of more than one DTAA, such relief has to be worked out with reference to each such agreement and not with reference to aggregate of tax on all the foreign income of such taxpayer⁶. CBDT has notified Foreign Tax Credit rules laying down broad principles and conditions for computation of foreign taxes paid in overseas countries by resident taxpayers. . It is to be noted that any availment of credit under section 91 should be done after referring to such rules.

The provisions for relief available under the treaty, to avoid double taxation of the income, are discussed in detail in the Chapter V under the section dealing with Article 23 'Elimination of Double Taxation'.

⁶ Bombay Burmah Trading Corporation Ltd (2003) 259 ITR 423 (Bom)

5

DOUBLE TAXATION AVOIDANCE AGREEMENTS

5.1. Concept of double taxation

While the globe converges into one big market place for purchase and sale of a variety of goods and services, each jurisdiction fights to tighten its rope to grab its share of taxes. This more often than not creates a situation where one single source of income may get taxed twice over in different jurisdictions based on taxation laws of the respective countries.

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- Capital-Import neutrality or Foreign Competitive Neutrality
- National Neutrality

Each of these standards is explained in brief below.

5.3.1 Capital export neutrality

This standard is fulfilled if the taxpayer's choice of investment (i.e. whether to invest

² POEM- place of effective management

Double Taxation Avoidance Agreements

in his home country or to invest overseas) is not influenced by taxation. In other words, the tax consequences are the same whether the taxpayer invests in his home country or abroad. This would result in an efficient allocation of capital and the decision to invest would depend upon business considerations rather than upon tax rates. This can be achieved if the home country, either by unilateral action, or by bilateral agreements, ensures that the taxpayer will not pay more taxes if he invests abroad. Capital export neutrality seeks to support either a purely residence-based system or worldwide source-based taxation with an unlimited foreign tax credit. For example, if an Indian company invests abroad say in the USA and the USA taxes the income on a 'source' basis. India will obviously tax the said income on the principle of residence. So, if the elimination of double taxation was not present in the India-USA DTAA, the Indian company would have to pay taxes in both India and the USA. But, because India would allow credit for taxes paid by the company in USA, the transaction becomes capital-export neutral (subject to certain conditions) for the Indian company as it pays on an overall basis, the same tax as it would have paid had it invested in India.

5.3.2 Capital import neutrality

The concept of capital-import neutrality or foreign competitive neutrality envisages that all the enterprises investing in a country pay taxes at a similar rate. It requires that all investments in a given country pay the same marginal rate of tax regardless of the residence of the investor. This means that all business activity within a country is subject to the same over- all level of taxation. If capital import neutrality holds, all savers receive the same after-tax return, regardless of their residence. Capital import neutrality is believed to support taxation by the source country along with the residence country exempting foreign source income. For example, if a company incorporated in the USA was to invest in India, India would tax the said income on a 'source' basis. If under the treaty, the USA would exempt the income that was taxed in India, from tax in its own jurisdiction, it would achieve what is known as capital-import neutrality. Unfortunately, the exemption method would not achieve capital-export neutrality if the tax rate were to be lower in India as compared to that in the USA. The difference between the exemption method and the credit method is that the exemption method seeks to distribute the subject matter of taxation (i.e. the income) between the two jurisdictions whereas the credit method divides the tax itself.

5.3.3 National neutrality

This neutrality is sought to be achieved by allowing the tax paid in the foreign country

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as a deduction from the income when the same income is taxed in the home country. In other words, foreign tax paid is allowed as business expenditure in line with other non-income taxes such as sales tax, excise duty, octroi duty etc. This method is popularly called the 'deduction method' but is generally seldom used internationally.

Most countries follow a combination of the exemption method, the credit method and the deduction method to allow relief from double taxation method. A few countries however have certain very interesting variations. For example, Belgium follows what can be called a 'reduction' method. Under this method, income earned abroad is taxed at a concessional rate. Another method that attracts attention to international investors is the method followed in the Netherlands. The Netherlands at the first stage, applies the worldwide test of unlimited liability computing tax on income from foreign and domestic sources. Then, if income from a foreign PE has suffered tax abroad, the total tax due in Netherlands is reduced in the same proportion that the foreign income bears to the total income. In other words, the Netherlands sourced income is taxed at the progressive rate applicable to the total income and the progressive nature of the income-tax is not impaired. This, in Indian terminology, is giving credit at the 'average rate of tax'. This method is useful only where the income is taxed at varying progressive rates.

5.4. Methods of avoiding double taxation

5.4.1 Unilateral Relief

Section 91 of the Act, operates at two levels; sub-section (1) deals with the case of a resident who has earned income in a foreign country with which India has no DTAA. It is upto the resident to prove that the income did not accrue or arise in India but only in the foreign country and that tax has been paid thereon. If these conditions are met, the resident is allowed a deduction from the tax payable on the total income. The deduction is computed by applying the Indian rate of tax and the foreign rate of tax to such doubly taxed income and is restricted to the lower of the results of such taxes. If both the rates of tax are equal the Indian rate of tax is to be considered. The Indian rate of tax means the rate determined by dividing the amount of Indian income after all deductions/reliefs except this section by the total income. The foreign rate of tax means the total tax paid abroad divided by the income earned abroad. Section 91 (2) deals with income earned in Pakistan operates on almost similar lines as section 91 (1).

Section 91 (3) deals with the case of a non-resident who is assessed in India, whose share in the income of an Indian partnership includes income which has been earned income in a foreign country with which India has no DTAA and on which tax has

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been paid; he will be entitled to a deduction from such income for the tax paid in the foreign country and such deduction will be computed in the same manner as in the case of a resident described above.

Section 91 being a provision extending relief, requires that tax should have been actually paid. Pursuantly, no relief is available if no tax has been paid. This is also the distinction drawn by the Supreme Court in the case of ³*CIT v. Carew & Co. Ltd.* [1979] 120 ITR 540.

The expression 'such doubly taxed income' contained in the section indicates that it is only that portion of the income on which tax has in fact been imposed and been paid by the taxpayer that is eligible for double tax relief.

Is the doubly taxed income to be considered with reference to the total income or only against that income which has been doubly taxed was an issue, however the Supreme Court in the case of *Azadi Bachao Andolan (2003) 263 ITR 706 (SC)* has laid down the principle that it is not necessary that avoidance of double taxation can arise only when tax is actually paid in one Contracting State. In fact, the Supreme Court in an earlier decision in the case of *KVALM. M. Ramanathan Chettiar v. CIT* [1973] 88 ITR 169 also, held that the Act contemplates taxation of total income, though that income may be determined under different heads, the foreign income has to be included in the total income in India, the word "such" in the phrase "such doubly taxed income" refers to this foreign income which is again subjected to tax by being included in the total income. Income tax should be considered as leviable on such total income.

Thus, the Act vide provisions of section 90 ensures that where a DTAA is in existence, the taxpayer is not made to suffer double taxation, by a provision in the DTAA and where a DTAA is not in existence, the taxpayer is not made to suffer double taxation by giving a relief under section 91 of the Act in respect of the doubly taxed income.

In an interesting ruling in the case of *DCIT vs Tata Sons Limited (ITA No. 4776/ Mum/ 04)*, the Mumbai bench of the Tribunal held that the US federal tax and state tax paid in respect of income earned overseas are not deductible as expenditure incurred for earning income under section 37 of the Act. Tribunal further observed that though relief is not available for state income taxes paid under the India- US DTAA, the relief is available under Section 91 read with Section 90 of the Act.

This is an important ruling from the Mumbai Tribunal, where it has been held that foreign taxes (including state tax) paid by the taxpayer are covered by Section

³ This case was in reference to s.49D of Income Tax Act, 1922

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40(a)(ii) of the Act and therefore, not deductible as expenditure while computing taxable income under the Act. This decision was rendered in the context of India-USA DTAA, in terms of which only federal taxes paid in US are eligible for credit in India. The Tribunal also held that state taxes paid in US, which are not eligible for credit under the tax treaty, would be entitled to relief under Section 91 of the Act.

Relief under section 91(1) of the Act, is to be computed on country wise basis and not on basis of aggregation of income of all foreign countries. Where such relief is by way of the credit system, it is the lesser of the two taxes on the doubly taxed income. Where the taxpayer is entitled to relief in respect of more than one DTAA, such relief has to be worked out with reference to each such agreement and not with reference to aggregate of tax on all the foreign income of such taxpayer (Bombay Burmah Trading Corporation Ltd (2003) 259 ITR 423 (Bom)). CBDT has notified Foreign Tax Credit rules laying down broad principles and conditions for computation of foreign taxes paid in overseas countries by resident taxpayers. . It is to be noted that any availment of credit under section 91 should be done after referring to such rules.

5.4.2 Tax Treaties (Bilateral relief)

Double Taxation Avoidance Agreement (DTAA) also referred as Tax Treaty is a bilateral economic agreement between two nations that aims to avoid or eliminate double taxation of the same income in two countries. The basic objective is to promote and foster economic trade and investment between two Countries by avoiding double taxation.

Trade has now become global with goods and services seeking the best buyer and seller. To encourage trade and free movement of goods and capital, countries sign DTAA's. These DTAA's along with bolstering trade between nations also help in ensuring that a person is not burdened with taxes twice over on the same income.

5.4.3 Interpretation of tax treaties

DTAA's as we have seen earlier, aim at eliminating or reducing the tax burden of a resident of a Contracting State engaged in transactions with a resident of another Contracting State. The intention of the Contracting States for entering into a DTAA is to aid in enhancing trade. As the tax element is an important consideration for a businessman, he would always weigh his return on investments post tax. In order to attract more trade, which generates more employment, which in turn raises the disposable income and increases the purchasing power, giving a general boost to the economy; countries are willing to forsake a certain percentage of collection in revenues.

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As the problems faced by most countries in adopting the DTAA were largely similar, a need was felt to standardize the DTAA. As early as in the 1920s, the International Chamber of Commerce sought the help of the League of Nations to overcome the problem of double taxation. The need to standardize DTAA was felt to reconcile the laws and needs of different countries while preserving their individuality. A standardized DTAA would also help the persons for dealing in trade with different countries at the same time.

Model forms of the Convention were first prepared by the Fiscal Committee of the League of Nations in 1927. Later, the Committees conducted meetings in Mexico during 1943 and in London in 1946 to discuss the drafts and proposed minor variations. The Model Conventions were published in 1946 by the Fiscal Committee of the United Nations (UN) Social and Economic Council. These drafts were the starting point by Organisation for Economic Co-operation and Development (OECD) for its draft model DTAA.

There are three generally used Models of the DTAA:

A. OECD Model Tax Convention: The draft Model DTAA was first published by the OECD in 1963 and is updated periodically. The OECD model is generally regarded as favouring the developed countries, as it gives priority of taxation to the residence state over that of the state of source. OECD Model is the base on which other Models are built. It has also been used as a Model for negotiating Treaties between OECD Members and non-member countries.

India is not a member to the OECD. It has made certain observations/reservations with respect to the OECD commentary on some of the Articles. While the judiciary in India has made reference to the OECD commentary for the purpose of interpretation [see *Asia Satellite Telecommunications Co Ltd. (2011)(332 ITR 340)(Del)*], some judicial precedents have also recognised the reservations made by India while interpreting the DTAA [see *Linklaters LLP v. ITO (2010) (132 TTJ 20)(Mum) Trib.*], *Gracemac Corporation v. ADIT (2010)(42 SOT 550)(Del Trib.)*.

B. UN Model Double Taxation Convention: Since the OECD Model was regarded as furthering the interests of the developed countries, the developing countries prepared their own model in 1979, which is known as the 1979 UN Model Tax Convention. This was developed / modified further in 1980, 2001, 2011, 2014 and 2017, incorporating the changes gained out of the experience. As the OECD model was the source, both the drafts are largely similar and in fact most Indian DTAA are a mix of both the models.

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C. US Model Income Tax Convention: US Model serves as a model to negotiate Treaty with the USA. Like UN Model Convention, the US Model Convention is also based on the OECD Model. It adapts to the conditions peculiar to the US. The US Model convention was first published in 1976 and revised in 1977, 1981, 1996, 2006 and recently in 2016. USA has also published a Technical Explanation to explain / clarify the provisions in the Articles of the US Model Convention.

These DTAA Models have led to the development of international tax law besides harmonization of DTAA's at the time of negotiation and also at the time of interpretation of the DTAA's in the event of disputes. The thumb rule to be followed in the interpretation of a DTAA is that the provisions of the DTAA override the provisions of the Act, unless the provisions of the Act are more beneficial.

DTAA's not being different from other international agreements, are to be interpreted using the same principles accepted in the International law. Therefore, the principles set out in the Vienna Convention on the Law of Treaties will be applicable in interpreting the DTAA's in the case of conflict. The Vienna Convention on the Law of Treaties provides guidelines to the countries in legal interpretation of the treaties which are parties to this Convention. Even though India is not a party to the Vienna Convention, nonetheless, one may rely on this convention for the purpose of interpretation in case of ambiguity. The Delhi bench of Tribunal in the case of *British Airways Plc. (2002)(80 ITD 90)(Del. Trib.)* has taken recourse to the Vienna Convention for the purpose of interpretation of double taxation treaties.

The General Rule of interpretation as provided in Article 31 of the Vienna Convention are as follows:

- A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
- The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
- There shall be taken into account, together with the context:

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- (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) Any relevant rules of international law applicable in the relations between the parties.
- A special meaning shall be given to a term if it is established that the parties so intended.

The U.S. Court in the case of *Scotland West Life Insurance Co. Canada v. CIR* (1996) (107 TC US 363) has cited the following principles of precedence for the guidelines in interpretation of the DTAA:

- i) The meaning should be consistent with genuine shared expectation of the contracting parties;
- ii) It should give effect to the purpose of the treaty. Where interpretations, both restricted and liberal are possible, the liberal interpretation should be preferred;
- iii) Words should be understood in its ordinary meaning unless it is specifically given a special or restricted meaning. As far as possible, the language in the law and the DTAA should be both effective;
- iv) Ambiguities could be resolved by making reference to the materials used during the process of negotiations, which can be given due weightage, though, it may not be conclusive.

In the context of reference to material used in the process of negotiation, different countries have taken different approach to the weightage to be given to the working papers on the negotiations between them. The purposive interpretation so as to meet the spirit and substance of the DTAA has been recognized by the Supreme Court in the case of *Azadi Bachao Andolan* [2003] 263 ITR 706 (SC).

Thus, the International law on the subject would also throw light on the interpretation when recourse to domestic case law does not throw much light.

The provisions of the DTAA override the provisions of the Act. The landmark decision of the Andhra Pradesh High Court in the case of *Visakhapatnam Port Trust* (1983)(144 ITR 146)(AP) has considered the international law on this subject and concluded that the universal opinion is that DTAA overrides the provisions of the Act.

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In the case of *Hindustan Paper Corporation Ltd. (1994)(77 Taxman 450)(Cal)*, the question before the Court was whether the definition of royalty in the Act was to be ignored in favour of the definition in the DTAA. The Court has ruled that section 90 of the Act clearly provided that the provisions of the DTAA would override the provisions of the Act to the extent they are more beneficial. The court also held that where there is no specific provision in the DTAA, the Act should be followed. Similar views have been expressed in the case of; *Arabian Express Line (1995)(212 ITR 31)(Guj)*; *R.M.Muthiah (1993)(202 ITR 508)(Kar)*; *Davy Ashmore India Ltd. (1991)(190 ITR 626)(Cal)* and in the Circular issued by the CBDT No.333 (137 ITR (St.)1), dated 2 April 1982.

However, the Delhi Bench of the Tribunal in the case of *Gracemac Corporation (2010)(42 SOT 550)*, held that the domestic law provisions can override the provisions of the DTAA, if they are enacted at a later point in time. Nevertheless, while arriving at such a conclusion, the Tribunal has not taken into consideration the above referred numerous rulings and the circular issued by the CBDT. Thus, adopting the view taken by the Tribunal in these decisions is not free from litigation.

If giving purposive interpretation results in uncertainty between the provisions of the DTAA and the domestic law, e.g. in a case where one country recognizes the 'person' as a 'resident' and another country does not recognize it as a 'person' per se, both the contracting states may opt to re-negotiate the DTAA.

The procedure for Mutual Agreement Procedure (MAP) provided in the DTAA's may also be resorted to when there is a conflict on the interpretations of the DTAA which are examined in detail in the Chapter dealing with MAP.

In addition to the Model Tax Conventions, one may also refer to the following for interpreting DTAA's:

- Overseas Laws and regulations pertaining to the other Contracting State;
- International decisions;
- Protocol to a DTAA;
- Technical Explanations to the DTAA (like Technical Explanation to India-USA DTAA);
- International Commentaries; etc.

In fact, now in a world of shrinking borders it is very important to understand the evolving law on problems of interpretation of the DTAA's. This is also evident with the introduction of BEPS Action Plan by the OECD, whereby the countries across the

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world are evaluating on amending the existing terms of the DTAA to factor the Action Plans. The countries are also proposing amendments in their domestic tax laws in line of the Action Plans.

5.5. Scope of tax treaties

The DTAAs are negotiated with an aim in achieving overall economic and trade advantages which a country expects to gain. Every country would be interested in entering into a DTAA to boost the inflow of trade. It may be in a specific field e.g. air transport, shipping, etc. or for a routine trade. Keeping this objective in mind, India has entered into many comprehensive DTAAs with different countries covering income exhaustively under different Articles and has also signed limited agreements only for air transport or shipping income with some countries. The DTAAs signed by India adopt provisions of either the UN or the OECD model or a combination of both.

A general overview of DTAA is as under (The Article numbers indicated herein may vary from DTAA to DTAA). For the purpose of forthcoming paragraphs, the UN Model convention is taken as base. Deviations if any from the OECD / US Model conventions are covered separately.

1. *Chapter I - Scope of the Convention* - This Chapter generally specifies whom the convention applies to and the taxes it covers (Article 1 - Persons covered; Article 2 - Taxes covered).
2. *Chapter II* - It defines the concepts of the DTAA and the terms used (Article 3 – General Definitions; Article 4 - Resident; Article 5 – Permanent Establishment).
3. *Chapter III - Taxation of Income* - This is the body of the DTAA. This Chapter deals with categorization of the income under various heads and the method of taxation of such income. (Article 6 - Income from Immovable Property; Article 7 - Business Profits; Article 8 – Shipping, Inland waterways transport and Air transport; Article 9 - Associated enterprises; Article 10 - Dividends; Article 11 - Interest; Article 12 - Royalties and Fees for Technical Services (FTS) (While FTS is not covered under any of the Model conventions, but it is covered under DTAAs signed by India with most of the countries); Article 13 - Capital Gains; Article 14 - Independent Personal Services (absent in OECD); Article 15 - Dependent Personal Services; Article 16 - Directors' Fees and remuneration of top-level managerial officials; Article 17 - Artistes and Sportspersons; Article 18 – Pensions and social security payments; Article 19 - Government Service; Article 20 - Students; Article 21 - Other Income).

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4. *Chapter IV* - Normally deals with Norms for Taxation of Capital [Article 22 – Capital (absent in U.S. Model)].
5. *Chapter V* - Contains special provisions to ensure elimination of double taxation (Article 23 - Elimination of Double Taxation). The U.S. Model convention also contains an additional article (Article 22 - Limitation of Benefits) which provides for conditions for claiming the benefits under the DTAA.
6. *Chapter VI* – Contains special provisions dealing with procedural recourse for grievances against unfair application / interpretation of the DTAA [Article 24 - Non Discrimination; Article 25 – Mutual Agreement Procedure; Article 26 - Exchange of Information; Article 27 – Assistance in the collection of taxes; Article 28 – Members of diplomatic missions and consular posts; Article 29 – Territorial Extension (present in OECD)].

The U.S. Model convention covers an additional article (Article 28 – Subsequent changes in law).
7. *Chapter VII* – This provides for the date when the DTAA would come into force and when it would be terminated (Article 29 - Entry into Force; Article 30 - Termination).
8. Protocol – Every DTAA would also have a protocol which is an integral part of the DTAA and explains in detail the provision of the Articles of the DTAA. The Protocol puts in the clarification arrived at by the Contracting States after exchange of letters on issues which need to be ironed out. The India-USA DTAA also has a long list of illustrations explaining the provisions of the DTAA. Exchange of notes and Protocol which are acted upon by the parties are also recognized in international law as a valid and binding agreement and do not need to be formalized. The Supreme Court also took due cognizance of the protocol appended to the India-Japan DTAA in its landmark ruling of *Ishikawajima-Harima Heavy Industries Ltd [2007] 158 Taxman 259 (SC)*.

A few of these Articles are analysed in detail in the ensuing paragraphs.

The DTAA should be read in connection with the Preamble, Exchange of Letter and Exchange of Notes to the DTAA, which contains the objects and the intention of the contracting states for entering into the DTAA.

Some DTAA's like the India's DTAA with the USA also contain a Technical Explanation which throw light on the intent of the DTAA and become a guide to understand the scope and extent of the DTAA.

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The scope of a DTAA is wide enough to encompass the various categories of income that may arise to ensure that the income is not doubly taxed in both the countries, and/or to allow credit for tax paid/deducted in the country of source.

The Calcutta High Court in the case of *Hindustan Paper Corporation Ltd. (supra)* touched upon an issue with respect to cases where there is no specific provision in the DTAA. It held that such income would be taxable under the Act. However, lately, there are diverging view from the courts on this issue viz. if there is no specific Article under the DTAA;

- (i) It should be taxable under 'Other Income' Article [see *Lanka Hydraulic Institute Ltd. (2011) (AAR)*];
- (ii) It should be taxable as business income only if it has a Permanent Establishment [see *Andaman Sea Food Pvt. Ltd. (2012) 18 ITR(T) 509 (Kol)*, *Essar Oil Ltd. (2005) (TII 24 ITAT Mum INTL)*, *Mckinsey Business Consultants Sole Partner LLC (2015) (54 taxmann.com 300) (Mum ITAT)*, *IBM India Pvt. Ltd. (2014) Bang ITAT (TS-78-ITAT-2014)*, *Viceroy Hotels Ltd. (2011) (TII 97 ITAT Hyd INTL)*, *Tekniskil (Sendirian) Berhard (1996) (222 ITR 0551) (AAR)*];
- (iii) It should be taxable under the Act (see *Gearbulk AG (AAR) (2009)*).

India deposited its instrument of ratification for the MLI on June 25, 2019 with the OECD conveying its final position on MLI provisions to implement tax treaty related measures for preventing BEPS. The MLI provisions have come into force for India on 1 October 2019, and are already into effect from 01 April 2020, to certain extent. Therefore, the articles of the DTAA's must be read correspondingly with the MLI articles. The government has also released the synthesized text of the DTAA's for countries that have deposited their instrument of ratification with the OECD and have listed India as one of the Covered Tax Agreements.

In the ensuing paras, we have covered the relevant provisions of the MLI corresponding to the provisions of the DTAA's. A general overview of the MLI is as under –

1. Part I – Scope and Interpretation of Terms – Scope of the Convention (Article 1), Interpretation of Terms (Article 2).
2. Part II – Hybrid Mismatches – Transparent Entities (Article 3), Dual Resident Entities (Article 4), Application of Methods for elimination of Double Taxation (Article 5)
3. Part III – Treaty Abuse – Purpose of a Covered tax Agreement (Article 6), Prevention of Treaty Abuse (Article 7), Dividend Transfer Transactions (Article

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8), Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property (Article 9), Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions (Article 10), Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents (Article 11).

4. Part IV – Avoidance of Permanent Establishment Status - Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies (Article 12), Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions (Article 13), Splitting-up of Contracts (Article 14), Definition of a Person Closely Related to an Enterprise (Article 15)
5. Part V – Improving Dispute Resolution – Mutual Agreement procedure (Article 16), Corresponding Adjustments (Article 17).
6. Part VI – Arbitration – India has not opted for this part and hence not being discussed.

5.6. Chapter 1 - Article 1: Persons Covered

Chapter I provides for the persons covered and the taxes covered under the DTAA.

For a taxpayer to be eligible to claim the DTAA benefit, it should first satisfy the requirement of Article 1. This Article is the core of any DTAA since it decides whether the taxpayer would be eligible to claim the benefits of the DTAA or not.

Article 1 of the UN Model Convention reads as under (this is similar to Article 1 of the OECD Model Convention):

“This Convention shall apply to persons who are residents of one or both of the Contracting States.”

Article 1 of the U.S. Model Convention is wider in scope. It reads as under:

- “1. *This Convention shall apply only to persons who are residents of one or both of the Contracting States, **except as otherwise provided in this Convention***
2. *This Convention shall not restrict in any manner any benefit now or hereafter accorded:*
 - a) *by the laws of either Contracting State; or*
 - b) *by any other agreement to which both Contracting States are parties.*

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3. a) *Notwithstanding the provisions of subparagraph (b) of paragraph 2 of this Article:*
 - i) *for purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that any question arising as to the interpretation or application of this Convention and, in particular, whether a taxation measure is within the scope of this Convention, shall be determined exclusively in accordance with the provisions of Article 25 (Mutual Agreement Procedure) of this Convention; and*
 - ii) *the provisions of Article XVII (National Treatment) of the General Agreement on Trade in Services shall not apply to a taxation measure unless the competent authorities agree that the measure is not within the scope of Article 24 (Non-Discrimination) of this Convention.*
- b) *For the purposes of this paragraph, a “measure” is a law, regulation, rule, procedure, decision, administrative action or any similar provision or action.*
4. *Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State.*
5. *The provisions of paragraph 4 of this Article shall not affect:*
 - a) *the benefits conferred by a Contracting State under paragraph 3 of Article 7 (Business Profits), paragraph 2 of Article 9 (Associated Enterprises), paragraph 7 of Article 13 (Gains), subparagraph (b) of paragraph 1, paragraphs 2, 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support), paragraph 3 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination) and 25 (Mutual Agreement Procedure); and*
 - b) *the benefits conferred by a Contracting State under paragraph 1 of Article 18 (Pension Funds), and Articles 19 (Government Service), 20 (Students and Trainees) and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that Contracting State.*

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6. *For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident.*
7. *Where an item of income, profit or gain arising in one of the Contracting States otherwise would be entitled to the benefits of this Convention in that Contracting State and, under the law of the other Contracting State, a person's tax in respect of such item is determined by reference to the amount thereof that is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the amount as is taxed in the other Contracting State.*
8. *Where an enterprise of a Contracting State derives income from the other Contracting State, and the first-mentioned Contracting State treats that income as attributable to a permanent establishment situated outside of that Contracting State, the benefits of this Convention shall not apply to that income if:*
 - a) *the profits that are treated as attributable to the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the permanent establishment is situated that is less than the lesser of (i) 15 percent or (ii) 60 percent of the general statutory rate of company tax applicable in the first-mentioned Contracting State; or*
 - b) *the permanent establishment is situated in a third state that does not have a comprehensive convention for the avoidance of double taxation in force with the Contracting State from which the benefits of this Convention are being claimed, unless the first-mentioned Contracting State includes the income treated as attributable to the permanent establishment in its tax base.*

However, if a resident of a Contracting State is denied the benefits of this Convention pursuant to this paragraph, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention with respect to a specific item of income if such competent authority determines that such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements of this

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paragraph (such as the existence of losses). The competent authority of the Contracting State to which the request has been made shall consult with the competent authority of the other Contracting State before either granting or denying a request made under this paragraph by a resident of that other Contracting State.”

The DTAA that are entered into by the Contracting states are applicable to the persons who are residents of one or both of the contracting states irrespective of their nationality.

The term “person” is defined under Article 3 dealing with “General definitions” to mean an individual, a company and any other body of persons.

The term “resident” is defined under Article 4 of the DTAA. According to this Article, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.

Thus, all those taxpayers who are satisfying the requirements to be a “person” as well as a “resident” are eligible to claim the benefits of the DTAA. On a conjoint reading of the above two definitions, one may infer that an individual or a company which is liable to tax in their respective contracting state would be certainly entitled to claim the DTAA benefit. However, in case of entities which are fiscally transparent, like partnerships, investment vehicles, etc. the eligibility to the treaty benefits is not clear. Similar issue also arises in respect of entities which are not taxable in their Contracting State on account of the domestic tax laws. These issues are discussed subsequently under Chapter dealing with Article 4.

If a person is considered as a resident of both the Contracting States, Article 4 provides for a tie breaker test for determining the State of residency for the person. This also has been discussed under Chapter dealing with Article 4.

One of the major issues highlighted by the BEPS Action Plan 2 on ‘Neutralizing the effects of hybrid mismatch arrangements’ was on taxation of fiscally transparent entities.

In line with this, MLI in its Article 3 on ‘Transparent Entities’ provides that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the laws of either contracting jurisdiction to a bilateral tax treaty shall be considered to be income of a resident of either jurisdiction only to the extent that such jurisdiction treats the income as the income a resident of such jurisdiction. This can be better explained with the following example –

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State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half its interest. One of the members is a resident of a State B and the other one is a resident of a country with which State A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

However, it may be noted that India has reserved its right to apply this article of the MLI and hence none of the DTAs with India shall be modified to the extent of this article.

5.7. Chapter 1 – Article 2: Taxes covered

Article 2 deals with the taxes which are covered under the DTAA.

The UN Model Commentary Clause on Article 2 reads as under (this is similar to **Article 2 of the OECD Model Convention** except for Paragraph 4 which uses the word 'taxation law' in place of 'tax law'):

“1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

(a) (in State A):

(b) (in State B):

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law.”

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Article 2 of the U.S. Model Convention reads as under:

“1. This Convention shall apply to taxes on income imposed on behalf of a Contracting State irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property.

3. The existing taxes to which this Convention shall apply are:

a) in the case of _____:

b) in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code (which do not include social security and unemployment taxes) and the Federal taxes imposed on the investment income of foreign private foundations.

4. This Convention also shall apply to any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws that relate to the application of this Convention.”

Each State imposes different taxes on its residents. Certain countries impose a tax on income as well as capital. Therefore, the taxes which are intended to be covered under the DTAA have to be specified. This Article defines the scope of application of the DTAA being taxes on income and capital. Generally, all non-governmental taxes, dues, duties, etc. are not covered by the DTAA's. Further, indirect taxes such as excise duty, sales tax, VAT, etc. are also not covered by the DTAA's. Social security charges, monetary fines and penalties, interest for late payment or non-payment of taxes, etc. are not regarded as taxes.

Paragraph 1 normally provides that all taxes imposed by the States, whether on income or on capital, or on its behalf by the local authorities or its political subdivisions will be covered. It also clarifies that the manner of levy is not important. The word 'imposed' means the levy of income tax on the income as per the law of the source State. There are three stages of tax liability; first is the determination of the liability; second is the assessment and the last is the recovery (*Chatturam Horilram Ltd. v. CIT (1955) (27 ITR 709) (SC)*). The manner in which the taxes are imposed by the State is not important i.e. whether done directly or withheld at source or on a presumptive basis.

While Paragraph 1 defines the authorities which have a right to levy the taxes and also defines the taxes, Paragraph 2 elaborates the ambit of taxes which are inclusive

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of taxes on alienation of property and any other tax which is peculiar to the Contracting States.

According to Paragraph 2, taxes on income and capital includes the following:

- Taxes imposed on total income and on total capital;
- Taxes imposed on the elements of income or of capital;
- Taxes on gains from the alienation of movable or immovable property;
- Taxes on the total amounts of wages or salaries paid by enterprises;
- Taxes on capital appreciation.

Income is not defined under the DTAA. Accordingly, its meaning has to be considered as provided under section 2(24) of the Act. Elements of income may include taxes on dividend, interest and capital gains [see *Cyril Eugene Pereira, In re (1999)(239 ITR 650)(AAR)*]. The paragraph also covers taxes on capital gains on alienation of movable or immovable property and on capital appreciation. It also covers taxes on wages and salaries.

Paragraph 3 specifies the existing taxes which are currently imposed by the States. These are the taxes which the convention intends to give relief from against double taxation.

Paragraph 4 normally provides for extending the benefit of the DTAA to taxes which may be imposed at a later date. It also puts an obligation on the States to keep each other informed on the change in law at the end of each year.

Paragraph 4, in fact, is an extension of Paragraph 3 since it prevents the treaty from becoming inoperative if one of the Contracting States modifies its tax laws.

The only difference in language of the UN Model Convention and the OECD Model Convention is the use of the expression “tax laws” and “taxation laws” in Paragraph 4. While UN Model Convention uses the words “tax laws”, OECD uses the words “taxation laws”. It is important to note the context in which the two are applied as they connote a different meaning. These terms are not interchangeable ‘Taxation’ covers the whole gamut from liability to the imposition and quantification of the tax. ‘Tax’ connotes only the liability aspect.

First the income liable to tax is identified and the tax thereon is restricted to the rate of tax prescribed in the DTAA.

The issue which arises in some cases is whether the rate of tax specified is inclusive of surcharge or is to be further increased by the surcharge and education cess

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specified as per the Finance Act. Since Article 2 of most of the treaties which India has entered into covers income tax including any surcharge thereon with respect to taxes for India, the specified rates ought not be further increased by surcharge and education cess [Sunil V. Motiani [2013] 33 taxmann.com 252 (Mumbai - Trib.), J.P. Morgan Securities Asia (P.) Ltd. (2014) 42 taxmann.com 33 (Mumbai - Trib.), BOC Group Ltd [2015] 64 taxmann.com 386 (Kolkata - Trib.), Parke Davis and Company LLC (2014) 41 taxmann.com 193 (Mumbai - Trib.).

What is essential to keep in mind while interpreting a DTAA is that it does not require actual payment of tax to claim the benefit. If a person is liable to be subjected to tax, he would be entitled to claim the benefit of the DTAA. Therefore, the Contracting State must have a right to make a person liable to tax either in the present or at any future date. This was the view taken in the case of *Mohsinally A. Rafik* (1995) 213 ITR 317 (AAR) wherein the AAR held that though the individual, at present, was not actually liable to pay tax in UAE, he would still be a resident of UAE as his source of income was in UAE; so he could be called upon to pay tax there. Contrary to this position, the AAR in the case *Cyril Eugene Pereira* (supra) held that if a person has not been actually subjected to tax, he would not be entitled to the benefits of the DTAA. However, as said earlier, the Supreme Court in the case of *Azadi Bachao Andolan* (supra) has held that the view taken in the case of *Mohsinally A. Rafik* (supra) is the correct interpretation of a DTAA. The principle laid down in the case of *Mohsinally A. Rafik* (supra) has been upheld subsequently in the case of *Prashant Kumar Gulati* [2014] 50 taxmann.com 415 (Pune - Trib.), *Vinod Arora* (2012) 26 taxmann.com 23 (Delhi), *Emirates Shipping Line, FZE* [2012] 23 taxmann.com 400 (Delhi), *Green Emirate Shipping & Travels* (2006) 100 ITD 203 (Mum), *MUR Shipping DMC Co., UAE* (2015) 62 taxmann.com 319 (Rajkot - Trib.).

This controversy with respect to 'liable to tax' under the India - UAE DTAA was resolved by making an amendment in the definition of 'resident of the Contracting State' vide Protocol dated 27 March, 2007. Nonetheless, the principles laid down in these decision would still hold good to address the issue of eligibility to claim the DTAA benefit where the person may not actually be liable to tax in a Contracting State by virtue of an existing legal provision but where that Contracting State has the right to tax such persons irrespective of whether or not such a right is exercised by the Contracting State.

5.8. Chapter II – Article 3: Definitions

Article 3 normally contains the 'definitions' which explains the terms used in the DTAA. Terms like 'resident' and 'PE' which require detailed explanation are defined

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in separate Articles. While the number of terms defined may vary from DTAA to DTAA, the terms defined would normally be 'person'; 'company'; 'enterprise of a Contracting State'; 'enterprise of the other Contracting State'; 'international traffic'; 'competent authority'; 'tax'; 'State', etc.

A definition limits the meaning to be given to a term while interpreting the Article. Definition is a statement that sets forth and delimits the meaning of a word. Definition performs two functions, namely, (i) the avoidance of ambiguities; and (ii) the avoidance, by means of abbreviation of tedious repetitions. The Supreme Court in the case of *S. Sundaram Pillai v. V.R. Pattabiraman (AIR 1985 SC 582)* held that if a definition is provided to an expression, the courts are not free to construe the expression otherwise unless it is so warranted by the use of the expression such as 'except otherwise provided' or 'except if the context otherwise indicates'.

The 'definitions' Article deals with general terms which are used throughout the DTAA. Specific terms such as 'Royalty', 'Interest', and 'Dividend' are defined in the Article dealing with the treatment of the specific income. A definition of a particular term helps in the interpretation of the Article and makes it clear as to who is identified for relief or what is included. Terms not defined in the DTAA have the meaning which they have under the domestic law of that State concerning the taxes to which the DTAA applies. The reason for adopting a reference to the domestic law is that since the DTAA relieves from tax, it is necessary for the relieving provisions to follow the definitions used in the taxing provision. The terms generally defined under the DTAA are explained below (for the purpose of this Article reference is made to definitions covered in India-UK DTAA):

- (i) *"(a) the term "United Kingdom" means Great Britain and Northern Ireland;*
(b) the term "India" means the Republic of India;"

In the context of India-UK DTAA, the first two terms which are defined relate to the two states which are party to the DTAA. These are generally referred to as the 'Contracting State' individually and 'Contracting States' collectively. Further, each State is individually geographically defined.

Usually there is also a provision to include the expansion to the State in the future. This is especially important in the context of countries which are a group of countries. Both the Contracting States in the DTAA are referred to as the State. This creates ambiguity on the first reading of the Article. Generally the words 'that State' refers to the first State and the word 'other State' refers to the second State. Most of the DTAA's define which is 'the contracting state' and 'the other contracting state' between the two parties which have entered into the DTAA.

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(ii) *“(c) the term "tax" means United Kingdom tax or Indian tax, as the context requires but shall not include any amount which is payable in respect of any default or omission in relation to the taxes to which this Convention applies or which represents a penalty imposed relating to those taxes;”*

The term ‘tax’ further defines the ‘taxes covered’ and specifies what shall not be included. Normally, penalties and penal or compensatory interest is excluded. The taxes which are covered would normally include income tax including surcharge and the taxes which are specific to each State e.g. India would include wealth tax, India-Netherlands DTAA includes, in the context of Netherlands, dividend tax, capital tax, wages tax and company tax also. Different countries have different methods of taxing income and/or capital. Therefore, the taxes covered have to be specified. In case of dividend income, the issue arises in a case where tax is levied on company on distributed dividend which is exempt in the hands of the shareholders. Therefore, whether the shareholder is entitled to proportionate credit in its own hands on the tax paid by the company depends on how the DTAA is worded. Some DTAA's contain a mechanism to allow underlying tax credit which is similar to tax paid by the company on the dividend distributed by it. This concept is elaborated in the subsequent chapter dealing with Foreign Tax Credit.

(iii) *“(d) the term "fiscal year" in relation to Indian tax means "previous year" as defined in the Income-tax Act, 1961 (43 of 1961) and in relation to United Kingdom tax means a year beginning with 6th April in one year and ending with 5th April in the following year;”*

As different countries follow different financial years, it is necessary to define the period covered. E.g. in India, the income of the previous year i.e. the financial year ending on 31 March of the preceding year forms the basis of the charge. Therefore, it is necessary to stipulate the financial year in a manner that can be understood internationally. Both the UN Model Convention and the OECD Model Convention did not feel it necessary to provide for a comparative base in such cases. This definition is essential to avoid any controversy at the choice of comparable year to provide relief or credit of tax as the case may be. Where the relief depends upon the duration of the stay, as in the case of salary income, the financial year as per the country from which the salary income is received may be considered.

(iv) *“(e) the terms "a Contracting State" and "the other Contracting State" mean India or the United Kingdom, as the context requires;”*

This definition provides that the two States which are party to the DTAA are to be referred to as “a Contracting State” and “the other Contracting State” depending on

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the context in which the Articles are read. Generally, the resident of India will consider India as the “Contracting State” and United Kingdom as the “other Contracting State”.

(v) “(f) the term “person” includes an individual, a company, a body of persons and any other entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting States;”

The step of determining whether an entity is to be considered to be a ‘person’ is the most important step and the starting point in the application of the DTAA. This may sound simple, but it can get very complicated when considering the case of entities, such as partnerships which may not be taxable in one of the Contracting States; and joint ventures which may require interpreting not only whether it is a ‘person’, but whether it is a ‘resident’ for the purpose of the DTAA being invoked.

‘Person’- is generally defined to include ‘an individual’, a ‘company’ and any other ‘body of persons’. If a country specifically does not recognize an entity as a ‘person’ in its tax laws, it may wish to specifically exclude that entity from the definition of person so as to restrict the application of the DTAA to that entity.

Normally the terms would also have to be interpreted in the context of the local laws e.g. the term ‘individual’ would have to be given the meaning the way the local law and the local courts have interpreted it. The DTAA also recognizes artificial juridical persons such as a ‘company’, an ‘Association of Persons’, ‘Body of Individuals’ which are also normally recognized as taxable entities under the States’ Income Tax Act under the definition of “person”.

When a Contracting State recognizes an entity as a taxable entity but the other Contracting State does not recognize it so, the issue arises as to how the DTAA should be applied to ensure that its spirit of avoiding double taxation is maintained. This ought to be done at the time of negotiation and drafting of the DTAA or can be done by subsequent amendment by mutual consent to the DTAA. e.g. Partnerships are treated as transparent entities in certain Countries and the tax is levied on the partners, whereas countries like India treat the partnership as a taxable entity and exempt the income in the hands of the partners. The question that arises here is should India grant the benefit of the DTAA to the ‘partner’ or the ‘partnership’ or to neither on the ground that tax is not paid in the country of residence?

This issue came up for adjudication before the Mumbai bench of the Tribunal in the case of *Linklaters LLP (supra)*. In the facts of this case, the taxpayer was a UK based partnership firm carrying on legal advisory business. The question arose on the treaty entitlement by the taxpayer in India on account of asymmetrical taxation of partnership firms in India and UK. In UK, the firm is treated as fiscally transparent

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entity and tax is payable by partners in respect of income earned by the partnership firm. India taxes the partnership firm on the income earned by the firm. In this ruling, after an elaborate discussion, the Tribunal held that the treaty benefits cannot be denied to the taxpayer even when a partnership firm is taxable in respect of its profits, not in its own right but in the hands of the partners, as long as the entire income of the partnership firm is taxed in the residence country. Thus, it flows from the ruling that considering the spirit of the DTAA, its benefits should be made available.

In order to give clarity on this issue, subsequently the DTAA between Indian and UK, was amended vide Notification No. 10/2014 [F. No. 505/3/1986-FTD-I] dated 10 February 2014 to allow the treaty benefits to partnership even in case where the income derived by it is subject to tax either in its hands or in the hands of its partners [This was done by deleting the words “does not include a partnership” from the definition of person].

Another example of this issue (i.e. whether an entity which is not taxed in the other Contracting State is entitled to the benefits of the DTAA) is in the context of residents whose income is exempt from taxation under their domestic tax laws. This has been discussed earlier in paragraphs dealing with Article 2 i.e. “Taxes covered”.

(vi) *“(g) the term “company” means any body corporate or any entity which is treated as a company or body corporate for tax purposes;”*

The term ‘company’ has been defined to mean any body corporate. This definition is further elaborated to specify that the definition under local laws would also have to be considered. Therefore, if a body corporate is considered as a company under Indian law it would be a company for the purpose of the DTAA also.

(vii) *“(h) the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;”*

‘Enterprise of a Contracting State’ and ‘Enterprise of the other Contracting State’ means an enterprise carried on by a resident of one of the Contracting States. Internationally, Courts have held that if transaction is undertaken for commercial and business purposes, it amounts to an enterprise. In common parlance, ‘enterprise’ means an economic activity carried on by a person, capable of producing profits. The Indian courts have dealt with the meaning of the term “enterprise” in the case of *Ensco Maritime Ltd. v. DCIT [2004] 91 ITD 459 (Del Trib.)* and *DCIT v. ITC Ltd. [2003] 85 ITD 162 (Cal Trib.)*.

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(viii) *“(l) the term "competent authority" means, in the case of the United Kingdom, the Commissioners of Inland Revenue or their authorised representative, and in the case of India, the Central Government in the Ministry of Finance (Department of Revenue) or their authorised representative;”*

This is the designated authority which is to be approached in the event of a dispute or where the resident of a Contracting State feels discriminated against in the other Contracting State. Normally the Ministry of Finance is the designated authority in India which can delegate its powers to the Tax Authorities.

(ix) *“(j) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State except when the ship or aircraft is operated solely between places in the other Contracting State;”*

This definition is important in the context of Article 8 (Shipping, inland waterways transport and air Transport) as it indicates who is entitled to the benefit of exemption of shipping income and also limits what is included. Normally coastal traffic and transport within the States is excluded.

Under the UN and OECD Model Convention provides the taxation rights in case of operation of ships or aircrafts to the state where the place of effective management of the enterprise lies.

(x) *“(k) the term "Government" means the Government of a Contracting State or a political sub-division or local authority thereof. In relation to the United Kingdom, the term "political sub-division" shall include Northern Ireland.”*

This defines the meaning of the term “Government” as is referred to in the DTAA to make reference to the Government of India or UK or a political sub-division or local authority thereof. And in the context of UK, the political sub-division is to include Northern Ireland.

(xi) *“The term “national” means:*

- (i) any individual possessing the nationality or citizenship of a Contracting State*
- (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.”*

This term is not defined in India-UK DTAA. This is specifically defined in the UN and OECD Model Convention. This definition includes individual and artificial juridical persons which derive their status from the laws of that State.

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Every DTAA has a residuary clause to stipulate that any term which is not defined, unless the context otherwise requires, will have the meaning which it has under the domestic laws of the Contracting States. In fact, when there are disputes in the interpretation of the terms not defined, the local laws and interpretation given by the local Courts are also referred to

5.9. Chapter II – Article 4: Residence under tax treaties

Article 4 of UN Model Convention reads as under:

“ARTICLE 4 – Resident

1. *For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.*

2. *Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:*

- (a) *He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);*
- (b) *If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;*
- (c) *If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;*
- (d) *If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.*

3. *Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the*

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purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

The difference in Article 4 of the UN vis-à-vis the OECD and the US Model Convention is as under:

Para	OECD Model Convention	US Model Convention
1	<ul style="list-style-type: none"> Does not contain "place of incorporation" The term 'recognized provision fund of that state' inserted 	<ul style="list-style-type: none"> Term does not include any person whose tax is determined in that Contracting State on a fixed-fee, "forfait" or similar basis, or who is liable to tax in respect only of income from sources in that Contracting State or of profits attributable to a permanent establishment in that Contracting State."
2		<p>Contains an additional paragraph as under: The term "resident of a Contracting State" includes:</p> <p>a) a pension fund established in that Contracting State; and</p> <p>b) an organization that is established and maintained in that Contracting State exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes;</p> <p>notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that Contracting State.</p> <p>Note: Paragraph 2 of the UN is similar to Paragraph 3 of the US Model Convention.</p>
3		<p>Following two additional paragraphs are as under:</p> <p>4. Where by reason of the provisions of paragraph 1 of this Article a company is a</p>

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Para	OECD Model Convention	US Model Convention
		<p>resident of both Contracting States, such company shall not be treated as a resident of either Contracting State for purposes of its claiming the benefits provided by this Convention.</p> <p>5. Where by reason of the provisions of paragraph 1 of this Article a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavor to determine the mode of application of this Convention to that person.</p>

This is one of the most important Articles in the DTAA. It is true that the DTAA deal with income, however, the income has to be identified with a source and with a 'person' in whose hands it can be taxed or to whom relief may be given. It helps in ascertaining the fiscal domicile of a person and the division of taxing rights between the Contracting States. Therefore, after considering whether a 'person' is as defined in the DTAA, it is essential to identify whether that 'person' can be considered as a 'resident' of a Contracting State; as the benefits of the DTAA can only be extended to the 'residents'.

Even the provisions of section 90(4) of the Act, requires the non-resident assessee, to obtain a certificate of his residency from the Government of its country of residence in order to entitle him to claim the DTAA relief.

The ensuing paragraphs discusses elaborately Article 4 of the UN Model Commentary.

Paragraph 1 defines the expression "resident of a Contracting State" to mean any person who is liable to tax in a particular Contracting State and specifies the criteria under which he may be so liable i.e. by reason of his domicile, or in the case of a company by reason of the fact that it is owned and/or managed in that State. Paragraph 1 fixes the residential status by applying the criteria such as domicile, residence, place of incorporation, place of management, as laid down under the domestic law of the State, to arrive at the tax liability which is also dependent on the source of the income in that State.

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Paragraph 1 covers a person based on his domicile, residence, place of incorporation, place of incorporation, place of management or any other criterion of a similar nature.

Criteria for determination

Paragraph 1 lists the criterions to determine 'residency'. The criteria laid down would normally be domicile, residence, place of incorporation, place of management or any other similar criterions. These are used to indicate some connection between the person and the State seeking to impose the tax. Therefore, what is important is that there should be some kind of a nexus or a physical connection between the person and the State which seeks to impose the tax.

Normally, where an individual is a citizen of a particular State and is regularly staying in that State, no dispute would arise as to which State he is a resident of. However, in a world of shrinking borders, it is possible that a person may be a national of one State while he may have a habitual abode in another and an economic / financial connection with a third State. In order to resolve such conflicts, Paragraph 2 lays down the tiebreaker tests.

It is important to note that Paragraph 1 uses the words 'liable to tax'. Therefore, as discussed in paragraph dealing with Article 2 i.e. 'Taxes covered', the expressions 'liable to tax' means a person on whom the State has the authority to levy a tax and not the actual quantum of the tax, as the words used are 'liable to tax' and not 'subjected to tax'. A person can be subjected to the tax laws of that State, whether in the present or at a future date. The nexus is connected to the source of income and not to the taxation of it.

In the landmark case of *Union of India v. Azadi Bachao Andolan (supra)*, the expression "liable to tax" was discussed in detail. It arose out of the issue whether avoidance of double taxation could mean that a person has to pay tax at least in one country or does it mean that if a person does not pay tax in any country whatever. The issue arose out a circular of the CBDT (No. 789 dated 13 April 2000) which, *inter alia*, stated that Foreign Institutional Investors (FIIs) and another investment fund, etc. which are operating from Mauritius are invariably incorporated in that country and these entities are "liable to tax" under the Mauritius Tax law and are therefore considered as residents of Mauritius in accordance with India-Mauritius DTAA.

According to this circular, capital gains were not to be taxed in India as well in Mauritius (on account of its local laws). Thus, since capital gains were not getting taxed in either of the Contracting States, the question arose whether the phrase "liable to tax" as used in Article 4(1) is the same as "pays tax".

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The Supreme Court observed that merely because the exemption has been granted in respect of taxability of a particular source of income, it cannot be postulated that the entity is not "liable to tax". The court held that liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the DTAA, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, the DTAA would not have used the words "liable to taxation", but would have used some appropriate words like 'pays tax'.

The Mumbai Bench of the Tribunal in the case of *ADIT v. Green Emirates Shipping & Travels (100 ITD 203) (Mum)* took cognizance of these observations of the Supreme Court and further held that a DTAA not only prevents 'current' but also 'potential' double taxation. Irrespective of whether UAE actually levies income-tax on any person, once the right to tax UAE resident vests only with the UAE Government, that right, whether exercised or not, continues to remain an exclusive right of the UAE Government. To allow treaty benefits, all that is necessary to be seen is that the claimant of treaty benefits should be 'liable to tax' in the contracting state by reason of domicile, residence, place of management, place of incorporation or any other criterion of a similar nature which essentially is referred to the fiscal domicile of such a person.

Domicile - Domicile refers to the civil rights or the system of law a person is governed by. Domicile describes a connection a person has with a State which may or may not be his State of origin or nationality or citizenship. Domicile is distinct from citizenship. Domicile is a connection with a territory and does not imply nationality of a particular State. The domicile of origin is by birth and automatically entitles an individual to citizenship whereas domicile of a choice is where the individual chooses to live and where he would be taxable. The fiscal domicile is thus different from the political domicile.

Residence - The term residence is to be given its normal meaning and would imply a place where a person normally resides. It does not connote the place of origin. Residence implies some degree of permanence.

In a case of a company the place of effective management has to be considered. This was the view taken in *AAR No. P. 9 of 1995 (1996)(220 ITR 377)(AAR)* and *AAR No. P.10 of 1996 (1997) (224 ITR 413)(AAR)*. Internationally also, the view is that, the residence of the country is where the center of management and control actually abides [*De Beers Consolidated Mines Ltd. v. Howe (Surveyor of Taxes) (1906)(AC 455 (HL))*]. The control means control of the company's business and not the voting power.

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Any other criterion of a similar nature - Though normally words take color from the other words which accompany them, however the words “any other criterion of a similar nature” are used to broaden the scope of the Article. If there is a nexus between the income, the person, and the resident and if tax has been actually paid, then the benefit of the DTAA must be given.

Paragraphs 2 and 3 are important to establish who has the jurisdiction to impose and collect the tax. These two paragraphs have to be read as a whole.

Paragraph 2 provides for tiebreaker tests in case a person is a resident of both the Contracting States. This may happen in case of an individual who has a domicile in both the States. Paragraph 3 deals with a situation where a person other than an individual can be considered as a resident of both the Contracting States and provides that the place where the ‘effective management’ rests will be considered as the resident State.

Tie Breaker Rules - Paragraph 2 contains the tiebreaker rule. Where a person can be considered to be a resident of both the States, the tie breaker test as laid down in this paragraph has to be applied in the same order in which the selection is given to decide on the residential status of the person. The ratio behind this test is to give the benefit of the DTAA to the State which has the closest nexus with the income. It must be noted here that these tests are applicable only in the case of individuals.

The tests are:

1. Determination of where the permanent home of the ‘resident’ is located. The State in which the person permanently resides would be considered as the resident State. If there is a permanent home in both the States then, the next test is;
2. Determination of the centre of vital interest. The State with which the personal and economic relations are closer would be considered to be the State of residence. If that also cannot be determined then, the next test is;
3. Determination of the State in which he has a habitual abode. If he has a habitual abode in both the States then, the next test is;
4. Determination of the State of which he is a national. In case he is a national in both the States then, the last option available is;
5. The Competent Authorities will decide the State of residence.

As mentioned above, these tests have to be applied in the order stated and if a person satisfies one test there is no need to go to the other. This requisite may,

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however not always serve the purpose e.g. take a case where a person resides in a tax haven, however his economic and vital interests are connected with another State, should the State from where the income is generated lose out on the right to tax the individual? As a counter argument, the State where he is permanently residing may provide social benefits and therefore, claim a right to tax the individual. Such situations are best left to the courts or the Competent Authority to interpret keeping in mind the ultimate objective of the DTAA i.e. to avoid double taxation.

We shall now examine the above tests in a little more detail:

Permanent home - Though the concept of permanent home and domicile appear to be the same; in the context of treaty law they are given different meanings. While a domicile would be a place where a person has his permanent home, it could have different meaning at different points of time. A domicile, unlike citizenship, is a matter of choice. A person may get citizenship on birth but a domicile is where he chooses to stay. Under the DTAA a permanent home need not be a domicile, as under the treaty law a domicile is of a special type where a person stays more than occasionally or for more than a short time though, may be not permanently. A permanent home, in a way, can be interpreted with reference to the opposite i.e., what is not to be considered as a temporary home. This is also required to be weighed with the intention of the person and the facts of each case e.g. if a person has been seconded to another country for a period of two-three years, it does not mean his permanent home has changed though, the other country may get a right to tax him on the income earned. The permanent home is in the country of residence though on account of the secondment, the person may not be staying there for the moment. No rules can be laid down to determine what can be considered as permanent home and the answer would depend on the facts of each case. The existence of a business interest, ownership of a property, family and financial indicators like bank account investment should be taken into consideration to determine the permanent home.

Centre of vital interests - The phrase 'home is where the heart is' seems to apply to interpretation in Treaty law as well. It is generally interpreted that in the case of a married man his home would generally be the place where his family resides whereas for a single person it would be the place with which he has an economic interest. Therefore, just because a person retains a permanent home in say, India where he was born and brought up before shifting to another country from which he derives his income and where his family is residing with him, it cannot be said that India is the permanent home as his centre of vital interest is in the other Country. This was also the view taken by the AAR in the case of *Mohsinally A. Rafik (supra)*.

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Habitual abode - The word 'habitual' implies some sort of continuity and is derived from the word 'habit' which implies a tendency to repeat the same action. An 'abode' is a place of residence. Therefore, if a person has been staying in one place for a long and continuous period of time, it could be called his habitual abode.

Nationality - Nationality means place of birth. This test is applied last when all the other tests fail. A person has a relationship of rights and duties with his State of origin. This test is put last as in Treaty law it is the nexus with the income that is important and not the nexus with the State.

Competent Authority - The last resort when all else fails is to approach the Competent Authority for their expert opinion to determine the residential status.

What can be gauged from above is that most of the criteria are overlapping on elaboration and there can be no definite rules or tests laid down to determine the residence. Therefore, residency must be evaluated based on the facts of each case.

The tests laid down above, are with respect to an individual. Paragraph 3 of Article 4 deals with the determination of 'residence' of a company. The emphasis here is on the 'place of effective management'. There is a difference between the registered place of business and the actual place of business. This distinction is essential to understand as many companies set up their registered offices in tax havens while the actual business is managed from another country. Therefore, the DTAA's have a clause to state that the country from where the 'effective management' is carried on will be the country of residence. 'Effective Management' means the actual conduct of business, where the brain of the business is located and from where the decisions are taken. Therefore to break the tie between a country where the ownership rests and the management takes place, it is essential to ask the questions; (i) Who is in charge; (ii) Where is/are the person/s in charge operating from; (iii) Where are the finances being routed through. The competent authorities of the Contracting States shall endeavor to determine the place of effective management of a company by mutual agreement. In absence of such agreement, such company may not be entitled to any relief or exemption from tax provided in the DTAA's.

Like an individual a company may also have dual residency. Though the test applied to an individual cannot be entirely applied in case of a company, an analogy can be drawn. A company would be considered to have a 'home' where its board of directors are situated and from where the company is controlled and managed i.e. the place from where the policy decisions are taken. Mere activity in a place would not constitute residence of a company at that place.

In an interesting ruling, the Delhi Bench of the Tribunal in the case of *Radha Rani Holdings (P) Ltd v. ADIT (2007)(110 TTJ 920)(Del)* held that the "effective

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management and control of affairs” of the company was not in India on the following grounds:

- All the board meetings of the Singapore Company were held in Singapore and never in India;
- It is irrelevant that one of the directors is based in India, as long as the other member of the Board of Directors (who was also the Chairman of Board) was based outside India;
- A board meeting may be conducted by telephonic conversations or video conferencing. If one of the directors (based in India) participated in the board meeting by telephonically calling from India, it does not mean that the control and management of the Singapore Company was in India;
- Although the director based in India held 99 percent shareholding, all the directors enjoy equal powers, irrespective of their shareholding;
- The investment decisions or decisions to operate a bank account were taken outside India.

Similarly, in yet another interesting ruling, the Delhi Bench of the Tribunal in the case of *Saraswati Holding Corporation Ltd v. DDIT (2007)(111 TTJ 334)(Del)* relied in assessee’s own case for a different assessment year vide order dated 10 July, 2009 (2009) (2009 taxmann.com 1025) held that the place of effective management of the Mauritius based company was not in India. In this case, the Overseas Corporate Body (OCB) was incorporated in Mauritius and held by two non-resident Indians in USA. The OCB had executed power of attorney (POA) in favour of Indian residents and conducted the transactions through stock brokers in India. Based on these facts, the Tribunal went on to hold that the place of effective management of the Mauritius based company was not in India on the following grounds:

- POA merely empowered the persons in India to conduct business on behalf of the OCB;
- Directions were issued by two non-resident shareholders as evidenced by the telephone calls made to India from time to time; and
- The board of directors of the OCB had passed a resolution to grant authority to one of the two shareholders to take decisions.

To avail the benefits of a particular DTAA, it is thus necessary that the taxpayer be a “resident” of either of the States that have entered into the DTAA. This was viewed critically by the tax authorities, especially in case of “residents” under Mauritius tax

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laws. The CBDT issued administrative instructions clarifying that a Certificate of Residence issued by the Mauritius tax authorities would constitute sufficient evidence for accepting the status of Mauritius "residence" as well as beneficial ownership for applying the DTAA between India and Mauritius.

Pursuant to these administrative instructions, the tax authorities granted the benefits of the Mauritius DTAA to FII's in subsequent audit of their tax returns. Although the instructions were issued in respect of FII's and other investment funds, it was generally contended that the rationale should also apply to other investors investing into India through the Mauritius route.

The validity of the instructions was challenged in a Public Interest Litigation. The Delhi High Court quashed the instructions issued by the CBDT. The Union Government of India filed a Special Leave Petition before the Supreme Court, challenging the judgment of the High Court. The Supreme Court, vide its judgment dated 7 October 2003 reported in *263 ITR 706 [2003]* held that "liability to taxation" does not mean "payment of tax". For the purpose of definition of the term "resident" under a DTAA, what is relevant is the legal liability to tax in a particular country, and not the fiscal fact of actual payment of tax in that country. Merely because the Government of Mauritius had granted exemption from Mauritius tax to a particular source of income (e.g. capital gains), it cannot be said that the taxpayer is not 'liable to tax' in Mauritius.

The Supreme Court further held that the main function of a DTAA should be seen in the context of aiding commercial relations between the countries entering into it and as being essentially, a bargain between two treaty countries as to the division of tax revenues between them in respect of income taxed in both their jurisdictions.

The issue came up for adjudication before the AAR in the case of *E*Trade Mauritius Ltd* (AAR No. 826 of 2009), where the AAR reiterated the principles laid down by the Supreme Court in the case of *Azadi Bachao Andolan (supra)*. The principles laid down by the Supreme Court were also followed in the case of *Ardex Investments Mauritius Ltd., In re. (2011)(16 taxmann.com 84)(AAR)*. However, based on the facts of the case, the Bombay High Court in the case of *Aditya Birla Nuvo Ltd. (2011)(12 taxmann.com 141)*, denied the benefit provided by the India-Mauritius DTAA.

The CBDT has also issued a Circular No.1/2003 dated 10 February 2003, which in this context clarifies that if a company is a resident of both India and Mauritius, it will be taxed in the country from where it is effectively managed and controlled.

The place of effective management is only a tiebreaker test. Therefore, where a person is clearly a 'resident' based on 'liable to tax', the tiebreaker test need not be

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resorted to. The certificate of incorporation / residence issued by a Contracting State ought to be accepted. The decision of *E*Trade Mauritius Ltd (supra)* is a major relief for the taxpayers as it lays down several guidelines on the application and interpretation of the Treaty law, which should prevent undue harassment to the taxpayer, especially in the specific context of Mauritius, which is used as a hub for routing investment considering the unique opportunities it offers. This also underlines our earlier discussion that DTAA's are as much concerned with furthering economic interest as with collection of the States' fair share of taxes. However, this does not mean that the Courts have given a *carte blanche* to dummy companies set up in tax havens for routing investments. The Courts would go into the operations and legal structure of the company and any attempt to avoid tax would be struck down. This is also evident from the recent Protocol entered into by India and Mauritius on 10 May 2016 amending certain Articles of the DTAA including Article 13 which has made the gains from the alienation of shares acquired on or after 1 April, 2017 in a company which is a resident of India to be taxable. The protocol has also introduced a Limitation of Benefit Clause in the DTAA. Also, the new DTAA between India and Indonesia which was signed on 27 July 2012 and entered into force on 5 February 2016 includes an LOB clause.

Further, as discussed in the earlier Chapters, the provisions of the Act have also been amended to introduce the concept of Place of effective management for companies under section 6. Accordingly, while the DTAA provides for a tie breaker test in case of company where the place of effective management exists, the Act would provide this as a primary test to determine the residency.

The OECD in its BEPS Action Plan 2 dealing with Neutralizing the effects of Hybrid Mismatch arrangements has recommended changes to the tax treaties to cover cases of dual residency and transparent entities. These are discussed in detail in Chapter dealing with BEPS.

MLI has introduced Article 4 for taxation of Dual Resident entities. This article states that the competent authorities of the contracting jurisdictions shall endeavor to determine by mutual agreement the residential status of dual resident non-individuals by having regard to its place of effective management, the place where it was incorporated and other relevant factors. In the absence of such agreement, treaty benefits shall be denied to such person (unless otherwise agreed by them).

India has opted for this article to apply to its Covered Tax agreements. However, where another party to the MLI has made a reservation against Article 4, Article 4 will not apply with respect to the tax treaty between India and that party. Having chosen

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to not reserve against Article 4, India has provided a list of treaties and provisions therein which contain the place of effective management clauses which will stand replaced by the mutual agreement procedure. Where India's treaty partners' also notify the same clause, such clause will stand replaced by the provisions of Article 4. Where a treaty partner fails to notify the same clause in its bilateral tax treaty with India, then the provisions of such clause will apply to the extent that they are not incompatible with the provisions of Article 4.

5.10. Chapter II – Article 5: Permanent Establishment

Article 5 of the UN Model Convention reads as under:

“1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term “permanent establishment” includes especially:

- (a) A place of management;*
- (b) A branch;*
- (c) An office;*
- (d) A factory;*
- (e) A workshop;*
- (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

3. The term “permanent establishment” also encompasses:

- (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;*
- (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.*

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

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- (a) *The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;*
- (b) *The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;*
- (c) *The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
- (d) *The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
- (e) *The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;*
- (f) *The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e),*

Provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.1. Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same contracting state and:

- (a) *that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article,*
or
- (b) *the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,*

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person— other than an agent of an independent status to whom paragraph 7 applies—is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned

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Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

- (a) habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are
 - (i) in the name of the enterprise, or*
 - (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or*
 - (iii) for the provision of services by that enterprises,*unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1. would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or*
- (b) The person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of the enterprise.*

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. Paragraph 5 and 6 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned state as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent with respect to any such enterprise.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment

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or otherwise), shall not of itself constitute either company a permanent establishment of the other.”

9. For the purpose of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’ shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.

The difference in Article 5 of the UN vis-à-vis the OECD and the US Model Convention is as under:

Para	OECD Model Convention	US Model Convention
1	Similar	Similar
2	Similar	Similar
3	<p>Does not mention assembly and supervisory activities in connection with building sites, construction, assembly or installation projects.</p> <ul style="list-style-type: none"> • Building site or construction or installation project to constitute a permanent establishment only if it last for more than twelve months 	<ul style="list-style-type: none"> • Also includes an installation or drilling rig or ship used for the exploration or exploitation of the sea bed and its subsoil and their natural resources, situated in one of the Contracting States to constitute a PE only if it lasts, or the activities of the rig or ship lasts, for more than 12 months. • Also includes the situations listed below which can be considered to decide the threshold. For the sole purpose of determining whether the 12 month period referred to in this paragraph has been exceeded: <ol style="list-style-type: none"> a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation

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Para	OECD Model Convention	US Model Convention
		project and these activities are carried on during periods of time that in the aggregate do not last more than twelve months; and b) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises that are connected persons with respect to the first-mentioned enterprise, these different periods of time shall be added to the periods of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.
4	Unlike clause (a) and (b) of the UN Model, also excludes from the purview of PE, facilities solely for the purpose of delivery.	Unlike clause (a) and (b) of the UN Model, also excludes from the purview of PE, facilities solely for the purpose of delivery.
5	Clause (b) of Paragraph 5 is absent	Clause (b) of Paragraph 5 is absent
6	Absent	Absent
7	Almost similar to UN Model Convention.	Almost similar to UN Model Convention. UN Model further states when such independent agents could be considered to be not independent.
8	Similar to para 9 of UN Model	

The concept of PE is defined in Article 5 of the DTAA. This is one of the most important Articles of any DTAA. It is present in all the tax treaties that exist across all countries. This concept has also been referred under the domestic laws of India as business connection (BC) under section 9 and for the purpose of transfer pricing provisions it is defined under section 92F of the Act. This concept has been discussed in the earlier sections.

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The concept of PE must be examined along with the definition of BC under the Act. The discussion on BC would be incomplete without a reference to the landmark decision of the Supreme Court in the case of *R. D. Agarwal [1965] (56 ITR 20)(SC)*. The principles laid down therein of what constitutes a BC and on the apportionment of income are valid to date and are a useful guide in interpretation and understanding of the concept.

Both PE and BC require an element of continuity as distinguished from an isolated transaction. An isolated transaction may not always establish either. While an ongoing relationship would most definitely establish a BC; whether it would constitute a PE would depend on the other conditions specifically defined in the treaty being fulfilled.

We shall briefly examine the structure of the Article on PE to understand who and what can constitute a PE.

Paragraph 1 provides for a broad definition of PE to bring within its ambit any fixed place of business through which the business of the non-resident is carried on.

Paragraph 2 provides for a list as to what can be included under the definition of PE. Generally, a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources is included therein.

Paragraph 3 is a further extension of this definition to include a temporary fixed place PE like a construction site or supervisory activities rendered therein where the activity extends for a period of more than six months. This paragraph also stipulates that if consultancy services are rendered on a project for 12 months, even that service rendered would constitute a PE.

Paragraph 4 contains the exception to the definition of PE. Generally, following activities are excluded:

- Use of facilities or maintenance of stock solely for the purpose of storage or display of goods or merchandise belonging to the enterprise.
- Maintenance of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise
- Maintenance of fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise.
- Maintenance of fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

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- Maintenance of fixed place of business solely for any combination of activities mentioned above, provided that is of a preparatory or auxiliary character.

Paragraph 4.1 is an anti-fragmentation rule that was recommended by the OECD/ G20 BEPS Report on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). The purpose of this new paragraph is to prevent an enterprise from fragmenting its activities- either within the enterprise or between closely related enterprises- in order to qualify for the specific activity exemptions in paragraph 4 of Article 5.

Paragraph 5 is amended to address the artificial avoidance of PE status through commissionaire arrangements and similar strategies. The changes are in line with the recommendations for the OECD model convention in the OECD/ G20 BEPS Report on Action 7. Paragraph 5 deems a permanent establishment to exist if the person is a so-called dependent agent and carries out activities on behalf of an enterprise in the manner specified below:-

(a) if a person habitually concludes contracts in the name of the enterprise, for the transfer of ownership or the granting of the right to use the enterprise's property, or for the provision of services by that enterprise creates for that enterprise a close association with a state (or if they are habitually playing the principal role leading to the conclusion of such contracts);

(b) if a person habitually maintains in that state a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of an enterprise

This recommendation of the OECD / G20 BEPS have also been incorporated by Article 12 of the MLI.

The first paragraph of Article 12(1) of the MLI attempts to address the issue of commissionaire agreements and other similar arrangements by providing that a PE is deemed to be established where a person, on behalf of an enterprise, conducts certain activities in a Contracting Jurisdiction. These activities include:

- concluding contracts; or
- habitually playing the principal role leading to the conclusions of contracts that are routinely concluded without material modification by the enterprise; and such contracts are either (i) in the name of the enterprise; (ii) for the transfer of ownership or the right to use property belonging to the enterprise; or
- for providing services by the enterprise.

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Paragraph 6 normally deals with insurance companies. An insurance company carrying on business in India would be considered to have a PE, except when it is engaged only in re-insurance, i.e. if it carries on business through an exclusive agent.

Paragraph 7 provides that the activities of such an agent who represents a separate and independent enterprise would not constitute a PE.

The second paragraph of Article 12(1) of the MLI clarifies that paragraph 1 shall not apply if the person acting on behalf of the enterprise does so in an independent capacity and in the ordinary course of business. However, where such person acts exclusively or almost exclusively on behalf one or more enterprises to which is it closely related, that persons shall not be considered as acting as an independent agent.

Paragraph 8 excludes a subsidiary company from being considered as a PE.

Paragraph 9 explains the meaning of the concept of a person or enterprise “closely related to an enterprise” for the purposes of this Article and, in particular, of paragraph 4.1 and 6.

We shall now examine the above paragraphs in a detailed manner:

Paragraph 1: Fixed base - To constitute a PE there must be a business, the business must be carried on through a fixed place and the business must yield income. Further, the income only to the extent it could be attributed to that PE could be taxed. This is so as to strike a balance between the rights of a source state and a residence state to tax the income. Therefore, a source state is only given a right to tax the income when there is a constructive physical presence in that state; say in India of the non-resident enterprise. Accordingly, in order to attract taxation in a country the business which is carried out therein should have some degree of permanence. A reading of the OECD commentary suggests that even a pitch in the market place or a permanently used area in the customs depot would constitute a PE. What is essential is that the premises should be at the disposal of the non-resident and identifiable to it.

Klaus Vogel, in his commentary on the OECD Model Tax Convention has opined that the word ‘fixed’ has to be understood as fixed not with reference to the space or premises but with reference to the geographical location or area.

Mumbai Bench of the Tribunal in the case of *Airlines Rotables Limited, UK v. Joint DIT (2011) (44 SOT 368)(Mum)*, held that in terms of the provisions of Article 5(1), i.e. the basic rule, there are following three criterion embedded in the definition of PE and it is only when these three conditions are cumulatively fulfilled, a PE under the basic rule can be said to have come into existence:

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- physical criterion, i.e. existence of physical location at which business is carried out;
- subjective criterion, i.e. right to use that place;
- functionality criterion, i.e. carrying out of business through that place.

Considering the above, the Tribunal held that a place of business has to be at the disposal of the foreign enterprise for the purposes of its own business activities. This place has to be owned, rented or otherwise at the disposal of the taxpayer and a mere occasional use of the place does not suffice. The Tribunal further held that the PE must project the foreign enterprise of which it is claimed to be a PE and it is in this sense that the business must be carried on at the physical location in the other country.

The Supreme Court in the case of *CIT v. Coal Shipments Pvt. Ltd. (1971)(82 ITR 902)* held that an enduring benefit need not be of an everlasting character; but at the same time should not be so transitory i.e. it can be terminated at any time at the will of the parties. The word 'establishment' implies a continuity of an activity. The test of permanency, therefore, would not stop at mere ownership of an asset; because in such case there would be no 'establishment'.

Phillip Baker in *Double Taxation Conventions and International Law* ascribes three characteristics to a PE viz. 'stability, productivity and dependence', as understood by some decisions in Belgium, quoting from an Article by L. Denys titled 'The concept of Permanent Establishment in Belgium' [1975] ET 292.

Thus, the essence of a PE is the right to use the place with some level of permanence attached to it. However, permanence need not mean everlasting; but it should be something more than temporary. The term 'fixed place of business' does not mean necessarily something that is not stationary. What it means to convey is that, the place should be identified with the business. In this context, the AAR in the case of *P. No. 24 of 1996 (1999)(104 Taxman 377)* observed that even where the business is carried on through a mobile van; as long as that van can be identified as the place of business, it would constitute a PE. It accordingly held that a diving vessel fully equipped with all the equipment necessary to execute contract would be a PE. In the same ruling it has also observed that the word 'through a fixed place of business' is wide enough to take in any place at, in or through which a business may be carried out. The word is used to be consistent with the language of Article 7 which talks about the foreign enterprises making profit through a PE. The term 'fixed place of business' would therefore mean a place from where the services are rendered and which could be identified as the headquarters of the enterprise in India. It is not

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necessary that the place where business is carried out must be owned; as far as there is a right to use it.

The landmark observations of the Andhra Pradesh High Court in the case of *CIT v. Vishakapatnam Port Trust* [1983] (144 ITR 146)(AP) are worth noting:

“The expression ‘Permanent establishment’ used in the Double Taxation Avoidance Agreements postulates the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.”

The Delhi Bench of the Tribunal in the case of *Western Union Financial Services Inc. v. ADIT* (2006) (101 TTJ 56)(Delhi) has interpreted PE as a specific geographical point at the disposal of the non-resident through which a business is carried on. In this regard, it has considered fulfillment of two tests laid down for a fixed place of business to be considered as PE. Firstly, a PE should project the foreign enterprise in India and secondly, the taxpayer can, as a matter of right, enter and make use of the premises for its business.

The Special Bench of the Delhi Tribunal in the case of *Motorola Inc. (supra)* has dealt with a number of issues concerning taxation of non-residents engaged in telecommunication services which *inter alia* involved the issue whether the activities of the appellant taxpayers, on the facts of the case, would result into a business connection/PE in India, merely because the non-residents had wholly owned subsidiaries in India? The Special Bench observed that a PE, i.e. a ‘fixed place of business’ of a non-resident would exist in India if one is able to point to a physical location at the disposal of the non-resident through which its business is carried on in India. Employees of the non-resident supplier having use of its Indian subsidiary’s office as a matter of right would constitute a PE of the Non- resident supplier in India.

Some examples of ‘Place of business’:

- The residence of a country manager which is used as an office address [see *Sutron Corporation*, In re. (268 ITR 156);
- A fully equipped diving support/fishing vessel [see P. No. 24 of 1996 (supra); *GIL Mauritius Holdings Ltd.* (2011) (14 taxmann.com 77)(Delhi HC)];
- Office of Indian subsidiary [see *Motorola Inc. and Others v. DCIT* 96 TTJ 1; *Aramex International Logistics (P.) Ltd.*, In re. (2012)(22 taxmann.com 74 (AAR)); However, a mere presence of a branch or an office would not by itself attract taxation unless some activity is carried on there.

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The words used in Paragraph 1 also signify that it must be 'business' carried on by 'an enterprise'.

The terms 'business' and 'enterprise' have to be given their natural meaning. An 'enterprise' means an activity carried on by investing in terms of labour and capital and can be carried on through a partnership, a company or any other incorporated body of persons. However, business would not include 'independent professional services' which are dealt with independently in Article 14. Article 7 is restricted to commercial and industrial activities.

Paragraph 1 also uses the terms 'wholly' or 'partly' with reference to the quantum of the activity. The word 'wholly' does not mean that all the activities that the non-resident is engaged in should be carried on in India but that all the activities necessary for the business in India must be carried on through the PE or should have a connection with the PE. Therefore, as understood in the context of any business activity, there must be some sort of continuity of activity with respect to dealings with the number of transactions, etc. The word 'partly' is used to suggest that even if a significant portion of the activity is carried on it would constitute a PE.

Thus, Paragraph provides the basic rule to the definition of PE since it starts with the expression 'means'; whereas Paragraph 2 starts with the word 'includes' which is wider in scope. Thus Paragraph 2 widens the scope to include not only what is specified therein, but also what can fall within the definition even if not specifically provided.

Paragraph 2 gives an inclusive definition of PE and extends the scope and ambit of PE in addition to the main test covered under Paragraph 1 (i.e. having a fixed place of business). Accordingly, an issue arises whether only if the requirements of Paragraph 1 i.e. of having a fixed place of business is satisfied, there can be a PE? There are diverging on this issue. One view provides that Paragraph (2) is independent of Paragraph 1 since it is an include definition which adds to the primary definition to cover other places / persons, which may not be covered under Paragraph 1. The other view is that Paragraph 2 is not independent of Paragraph 1 as it merely extends the scope of Paragraph 1. Further, in order to fall under Paragraph 2, the business activity test as covered under Paragraph 1 will have to be fulfilled.

The Mumbai Bench of the Tribunal in the case of *Linklaters LLP* (supra) held that Article 5(2) consists of two heterogeneous categories of permanent establishments. The first category like branch, place of management, etc. consists of illustrations of what would constitute a PE, even under the basic rule and these examples are to be

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seen against the background of general definition given in Paragraph 1. The second category consists of installation PE and service PE, which can be termed as, extensions of the basic rule and deemed PE even though they may not necessarily satisfy the tests of fixed place of business laid down in Paragraph 1.

It is also worth noting that even OECD has endorsed similar stand in its Model Commentary where it observed that a building site or construction or installation project constitutes a PE only if it lasts for more than twelve months. Any of those items which do not meet this condition does not of itself constitute a PE, even if there is within it an installation, for instance an office or a workshop within the meaning of Paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in Paragraph, it will be considered a PE if the conditions of the Article are otherwise met even if one of the projects involved lasts for more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a PE, and it will be important to ensure that only the profits properly attributable to the functions performed through that office or workshop, taking into account the assets used and the risks assumed through that office or workshop, are attributed to the permanent establishment.

The different forms of establishment as covered under Paragraph 2 are briefly discussed below:

Place of management - This is where the head and the brain of the business are located. This is the most essential test of what can constitute a PE. The 'head and brain' in case of a company would be its Board of Directors. If the management has complete control and authority to make decisions and steer the business, a PE would most definitely exist. However, if the place of management only executed orders and carry out administrative functions, especially in case of an agency, it could be argued that it does not constitute a PE.

In the case of *Sutron corporation, In re [2004] 268 ITR 156 (AAR)*, the AAR held the Country Manager (CM) to be a dependent agent of the applicant who concluded contracts in India on behalf of the applicant. The AAR treated the residence of CM as a fixed business place in India of the applicant, which could be termed as place of management or an office. The AAR therefore held that the company has a PE and the profits of the company would be taxable in India to the extent attributable to the PE.

A branch - A branch is also an extension of an enterprise and would therefore constitute a PE. A branch office is not regarded as a separate legal entity. Its profits

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are the profits of the corporation owning the branch as held in the case of *CIT v. Stewart & Lyods of India Ltd. (1987)(165 ITR 416)(Cal)*.

An office – Similarly, an office is also an extension of an enterprise but the functions performed by it would be essential in determining whether or not it can be a PE. The word 'office' has different meanings when used in connection with an enterprise and with an individual. It means a place for transacting business when used in connection with an enterprise. If a representative office does not carry on any trading activity and does not receive any income but just acts as a place for distribution and dissemination of information, it would not be a PE. However, if it renders service and generates income on its own that income would be taxable. Therefore, a liaison office may not constitute a PE if the services are only of a preparatory or auxiliary nature.

A project office would *prima facie* constitute a PE [see AAR No. P 13 of 1995 *In re. (228 ITR 487), Micoperi S.p.A. Milano (2002)(82 ITD 369) (Mum)*. In the case of *Samsung Heavy Industries (2011)(13 taxmann.com 14)(Delhi)*, the project office of the company in India was held to be its PE. This decision was subsequently affirmed by the Tribunal (2013) (40 taxmann.com 165 (Delhi Trib.)). However, this case was set aside by the Uttarakhand High Court on the ground that neither the Assessing Officer, nor the Tribunal has made any effort to bring on record any evidence to justify that the Project Office of the appellant is its PE in India through which it carried on business and that 25 per cent of the gross receipt is attributable to the said business.

A mine, etc. - A source of income is always a PE e.g. a mine or oil well. These are included in the definition of the PE out of abundant caution to avoid any confusion.

Paragraph 3 of Article 5 provides for a further extension to the meaning of the PE. Under the UN Model Convention, this paragraph is divided into two clauses; a) construction PE b) service PE.

Clause (a) i.e. construction PE prescribes when a construction site can be considered to be a PE. Even in the absence of Paragraph 3 a construction site may be a PE within Paragraph 1 and 2. However Paragraph 3 puts a time frame to give relief to the temporary projects. This variation in time limit is a matter of negotiation. Countries which lend technology would like the period to be longer to avoid their residents from being taxed in the other country; whereas countries which borrow technology would like the period to be shorter so as to bring the non-resident to tax. This may go against the interest of some countries which would prefer not to give any relief to such projects as they are real money churners. However, again the collection of taxes would have to be weighed in the broader light of other economic advantages like generation of employment, increase in flow of foreign capital, etc. The balance is

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achieved by negotiating a mutually acceptable period of say 180 days, one year or may be even less. India has largely followed the UN model in most of its DTAA's with the period of construction PE varying from country to country.

In case of a construction PE the period referred to is with reference to a project and not the financial year, though some DTAA's like the US Model Convention provide for a period of 120 days in any 12 months period to constitute a PE. Very few DTAA's prescribe a cost of the project as against a period as a condition to create a PE. Therefore if the cost of the project exceeds say 10 percent of the cost of machinery it would constitute a PE. (Germany's DTAA with Tunisia)

The AAR in the case of *Cal Dive Marine Construction (Mauritius) Ltd. (2009) (182 Taxman 124)*(AAR) dealt with an issue on taxability in India in relation to the work of laying pipelines under the sea for an Indian company. On the issue of whether the activities of the taxpayer would constitute a PE in India under the India-Mauritius DTAA, the AAR specifically examined the Construction PE clause in the DTAA and how the prescribed threshold of 9 months needs to be computed. In computing this threshold, the AAR considered the preparatory activities for starting the project, but did not consider purely preliminary activities such as visits for negotiations / taking soil samples.

In the case of *Brown and Root Inc v. CIT (1999)(237 ITR 156)*, the AAR held that the work of installing pipeline did not constitute a PE as the project lasted only for 39 days. An Indian company was awarded a contract for installation of sub-sea gas pipeline and it sub-contracted part of the work to a Korean company, which in turn sub-contracted it to the taxpayer, a US company. The issue was whether the amount received by the assessee was exempt under the India-USA DTAA and not taxable in India in view of the fact that the US Company did not have a PE in India. The AAR held that as the contract was less than 120 days the company had no construction PE in India and the vessel could not be treated as a PE as there was a specific clause of Construction PE under which the presence of PE had to be examined and a specific Article would override a general Article.

In the case of *Valentine Maritime (Gulf) LLC (2011)(45 SOT 359)(Mum)*, the Mumbai Bench of Tribunal held that the aggregation of time spent on different projects can only arise for connected projects. Accordingly, connection would not arise only because contracts are carried out at nearby geographical location or for same person, but there has to be something in nature of work that must be connected. Thus, in the facts of this case, as there was no finding that there was any interdependence and interconnection between two contracts, PE was not constituted.

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The Mumbai Bench of Tribunal in the case of *Kreuz Subsea Pte. Ltd. (2015)(58 taxmann.com 371)* held that as the activities relating to construction or installation are specifically covered under Article 5(3), then one need not to go in Article 5(6) and, therefore, activity of assessee which was purely installation services had to be scrutinized under Article 5(3) only and not within article 5(6). The Tribunal further held that the threshold time-limit of 183 days under Article 5(3) of India-Singapore DTAA is to be calculated from the date of actual activity for installation purpose and not from date of signing of contract. It also held that for computing the threshold time-limit, unconnected or independent projects cannot be taken together and should be considered on standalone basis, even though different contracts may have been entered into by same customer with contractor.

Clause (b) of Paragraph 3 of the UN Model covers a specific class of PE i.e. "Service PE". This is not there under the OECD Model Convention. This Paragraph covers cases where a foreign enterprise forms a PE in India on account of furnishing of services through employees or other personnel. The paragraph provides for a threshold to determine the existence of PE.

For a foreign company to form a PE in India under Paragraph 3(b), the following conditions should exist:

- There has to be furnishing of services;
- By an enterprise;
- Through employees or other personnel engaged by the enterprise;
- Activities should continue in the other Contracting State for same or connected projects;
- Activities carried out should be beyond the threshold period provided in the article (say 183 days in any 12 month period).

This Paragraph applies only in respect of 'furnishing of services'. The expression 'furnishing of services' includes doing activities or operations which are integral or contributory to the provision of services [see *Worley Parsons Services (P) Ltd., In re (2009)(313 ITR 74)(AAR)*]. The services in this case, are to be furnished through the employees or other personnel engaged by the enterprise. The other personnel means personnel dependent on the foreign enterprise and may include individuals who receive instructions from the foreign enterprise (although not the employees of the enterprise) and employees of affiliates over whom the foreign enterprise has a control [see *Lucent Technologies International Inc v. DCIT (2009)(28 SOT 98)(Del)*, *eFunds Corporation v. ADIT (2010)(42 SOT 165)(Del)*].

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In the case of *AAR P. No. 28 of 1999 (2000) (242 ITR 208)*, the AAR held that where the non-resident not only supplies personnel but also assures supply of all inventions, ideas and improvements apart from confidential documents, though duties were of a technical nature, a continuous supply of personnel and know-how led to the inference of a PE, as the non-resident was conducting business through its personnel.

The recent judicial trend shows remarkable exposure in terms of Service PE being alleged on deputation of the employees. The matter has gained more attention since the case of *DIT (International Taxation) v. Morgan Stanley & Co. (2007) (292 ITR 416)(SC)* was decided by the Supreme Court. Though the matter had its genesis at an earlier time and there are reported cases prior to *Morgan Stanley* on this issue, the observations in *Morgan Stanley* and its interpretation later by the Delhi High Court in the case of *M/s. Centrica India Offshore Pvt. Ltd. vs. CIT (2014) (364 ITR 336)(Del)*, makes the issue more debatable.

The Supreme Court observed that the employee of a foreign company when deputed to the Indian company does not become employee of the Indian company. It further noted that a deputationist has a lien on his employment with the foreign company and as long as the lien remains with the foreign company, the said company retains control over the deputationist's terms of employment.

From above, it emerges that when deputation happens the employee of parent does not become an employee of subsidiary but there is a service element namely employee lends his experience to subsidiary as an employee of parent.

The Delhi High Court, in the case of *Centrica (supra)*, echoing the principles and ratio of the above ruling has noted and emphasized that in case of deputation, the employment relationship between the secondee and the overseas organization is at no point terminated, nor is Indian party given any authority to even modify that relationship. The High Court has in unequivocal terms held that the real employer of seconded employee continues to be the overseas entity concerned. The Supreme Court further rejected the petition filed by Centrica against the order of the Delhi High Court.

Accordingly, it appears that the authorities following the decision of the Supreme Court's in *Morgan Stanley* and the Delhi High Court's in *Centrica*, may generally take a view that in case of deputation of employees, there is rendition of services (imperative of whether the secondee report to the Indian Co and it is responsible for their work) through employees and, therefore, a Service PE.

However, the Mumbai Bench of Tribunal in the decision *Morgan Stanley International Incorporated vs. DDIT (International Tax) (2015) (53 taxmann.com 457) (Mum ITAT)*,

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has purely relied on Morgan Stanley's case for ruling that seconded employees were the 'real employees' of the US employer and constituted Service PE. This conclusion was reached even after acknowledging that the Indian company exercised control and supervision over the seconded employees and the employees were accountable to the Indian company.

For an enterprise to form a Service PE, the services are to be rendered in the other Contracting State i.e. in State of Source. Further, the activities have to continue for the same or connected project for a period exceeding the prescribed threshold. As the expression used is "same or connected projects", it ought not to cover unrelated projects. It is to be determined based on the interconnection in the nature of work involved in the two projects [see *Valentine Maritime (Gulf) LLC v. ADIT (2011)*(45 SOT 359 (Mum)).

The threshold as given in the UN Model Commentary is 183 days in any 12 months period. The period here applies in relation to the foreign enterprise and not to the individuals. Therefore, it may not be necessary that the same individual remain present in India to determine Service PE of the foreign enterprise. The commentaries in this respect have clarified that for the purpose of determining the threshold, one need to take into account the 'solar days' and not the 'man days'.

Exclusions - Just as the concept of PE is introduced to allow the source state to collect tax from business carried on in its territories, as per set law certain situations and transactions are excluded from the definition of a PE. These exceptions are listed in Paragraph 4 of Article 5. What can be observed from these exceptions listed is that, they do not involve any trade but only involve preparatory functions like warehousing, storing, etc.

Activities of preparatory or auxiliary nature are generally not considered as forming a PE. However, if these activities are essential to the formation of the PE they would also constitute a PE. In this connection, the decision of the Supreme Court in the case of *Morgan Stanley and Co. Inc. (supra)*, made pertinent observations. It held that carrying out of back office operations by the Indian subsidiary for the US parent does not result in formation of PE for the US parent company engaged in front office operations as the activities carried out by the Indian company would be in the nature of preparatory or auxiliary. The Delhi High Court in the case of *UAE Exchange Centre LLC (2009)*(183 Taxman 495)(Del) applied this proposition of the Supreme Court to hold that the activities carried out by the Indian liaison office were in the nature of preparatory or auxiliary character and reversed the decision of the AAR by holding that the foreign enterprise did not constitute a PE in India.

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The Delhi Special Bench of Tribunal in the case of *IAC v. Mitsui & Co. Ltd. (1991) (39 ITD 59)(Del)(SB)* held that the activities carried on were within the scope of the liaison office and no trading activity was being carried. Therefore, there was no PE in India.

In *Rolls Royce Plc, (19 SOT 42)(Del Trib.)*, the Delhi Bench of the Tribunal held that a foreign company availing support services from an Indian subsidiary had a PE in India. It was further held that the operations carried out in India cannot be regarded as preparatory or auxiliary functions because they were essential and significant part of the activity of the enterprise as a whole.

In a subsequent decision in the case of this assessee reported in *(2011)(13 taxmann.com 233)(Del)*, the High Court held that since the Tribunal held the Indian subsidiary to be PE of assessee in India, after critical analysis of material on record including objections and documents filed by assessee, there was no need to remand the case to Tribunal for that purpose. [The SLP in this regard has been granted by the Supreme Court and one need to keep a watch for the same.]

Delhi High Court in the case of *National Petroleum Construction Company (2016)(66 taxmann.com 16)(Delhi)* held that the inclusive definition of PE specified in Paragraph 2 of Article 5 of DTAA does not expand width of term 'PE'. It observed that even if a place of business squarely falls within definition of Paragraph 1 of Article 5 and is specifically listed in Paragraph 2 of said article, same would, nonetheless, not be construed as a PE of an enterprise, if it falls within any of exclusionary clauses contained in Paragraph 3 of Article 5 of the DTAA.

In this case, it was also held that where the assessee-company, in order to carry out contract for fabrication and installation of petroleum platforms, opened its project office in India, since said office was merely acting as a communication channel, it would clearly qualify as an activity of auxiliary character and, therefore, in terms of exclusionary clause (e) of Article 5(3) of the DTAA, it could not be construed as assessee's PE in India.

In the case of *Western Union Financial Services Inc. (2015)(64 taxmann.com 230)(Del)*, the Delhi Bench of Tribunal considered that liaison office could not be considered to be the fixed place PE of the assessee as it carried out activities which were of a preparatory or auxiliary character. This principle was also held in an earlier decision in the case of *DIT v. Nokia Networks OY (2012) (258 ITR 259)(Del)*.

However, where activities of liaison office of foreign company included not only preparatory or auxiliary service but also marketing services, liaison office would be treated as PE of foreign company and its income would be taxable in India [see *Brown And Sharpe Inc. (2014)(51 taxmann.com 327 (Allahabad)*].

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Article 5(4) of the OECD Model Tax Convention carves out a list of activities (the “specific activity exemptions”) that do not amount to a PE if a fixed place of business is used solely for such activities. BEPS Action Plan 7 confirms that when this list of specific activity exemptions was first introduced, the activities were generally considered to be of a preparatory or auxiliary nature. However, with the introduction of the internet and advances in related technologies, more and more businesses are operating within the newly developing ‘digital economy.’ As such, activities that were once thought to be merely preparatory or auxiliary are becoming the core activities of certain businesses. For example, activities such as holding goods in a warehouse in India may have typically been considered an auxiliary activity to the foreign company’s main activity of selling such goods through a brick and mortar storefront in India. Such storefront would have been sufficient to constitute a fixed place PE and allow the India to tax the foreign company. However, with the rise of e-commerce platforms the need for having brick and mortar stores has been eliminated. Foreign companies can easily sell their goods over the internet without having a physical presence in India. In such

instances, the foreign company’s activity in India is limited to the holding of goods in their Indian warehouse, which now becomes a core activity for their business. The provisions under Article 13 of the MLI are intended to ensure that such businesses do not avoid having a PE in a Contracting Jurisdiction merely because their activities, which are actually core to their business, fall within the specific activity exemptions.

Article 13 states that Parties to the MLI may choose between two options. Option A replaces existing treaty provisions to the extent that (i) all activities currently included in the treaty (whether or not they are of a preparatory or auxiliary nature); (ii) any other activity not already mentioned in the treaty; and (iii) any combination of activities in (i) and (ii), shall fall within the specific activity exemptions only if all such activity (or the overall activity of the fixed place of business from a combination of activities) is of a preparatory or auxiliary character. While Option A does not change the list of activities already negotiated between the Parties, it does ensure that all such activities must be of a preparatory or auxiliary nature in order to qualify as an exemption to establishing a fixed place PE.

Option B, on the other hand, allows for a little more flexibility as it does not require that all activities conducted from a fixed place of business be of a preparatory or auxiliary nature. While Option B provides that all activities (or combinations of activities) not already mentioned in the existing tax treaty must be of a preparatory or auxiliary nature to qualify under the specific activity exemption, this option also provides a carve out for any activity already existing in the tax treaty which is not

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specifically required to be of a preparatory or auxiliary nature. Such activity may continue to fall within the specific activity exemptions under Option B.

India has chosen to apply Option A to its Covered Tax agreements. Hence, only the corresponding DTAA with countries which have chosen Option A and have listed India as Covered Tax agreement shall be amended by the provisions of this Article.

Agency PE - Paragraphs 5 and 7 of the UN Model Convention relates to Agency PE, and an independent agent. Paragraph 5 of the UN Model Convention is divided into two clauses; a) with respect to an agent exercising the authority to conclude contract or plays a principal role leading to conclusion of contracts in the name of the enterprise (this clause is similar to Paragraph 5 of the OECD Model Commentary); and b) with respect to where the agent does not have authority to conclude contracts nor plays a principal role leading to the conclusion of contracts, but habitually maintains stock from which it regularly delivers goods on behalf of the enterprise (this clause is absent in the OECD Model Commentary).

A plethora of litigation is centered on whether an agency constitutes a PE. An agent simply means someone who acts on behalf of or for another. Most international trade is conducted through agents. To establish whether an agent constitutes a PE, the exact relationship between the parties has to be understood. What is essential is that the agent has to slip into the shoes of the non-resident and merely acting for and on behalf of the non-resident is not sufficient. If the agent services the non-resident in the normal course of his business while servicing other non-residents also, the agent would not constitute a PE. However, if he is an exclusive agent who can do everything what a non-resident would have done had he himself been present, such an agent will constitute a PE. Dependent agent would mean an agent who is legally and economically dependent on the principal.

The question to be asked in iteration is whether the place of business of the agent is identifiable as the place of business of the non-resident. The agent would constitute a fixed place of business; but that by itself is not sufficient. The fixed place should be identified as the place of business of the non-resident. Then next it has to be asked if the agent is independent. If not, then the extent of his authority has to be examined i.e. whether he can conclude contracts or is only an agent for warehousing or display of goods or purchase by another in wholesale. If he is not merely a purchasing agent i.e. the latter, but can conclude contracts, he would be a PE. Even when the agent is acting without contractual binding, he may form a PE.

The judicial precedents have held that as long as the agent has an authority to conclude contracts which are binding on the enterprise, it is not necessary that he

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should enter into contracts 'literally' in the name of the enterprise. Thus, the foreign enterprise would be considered as having Agency PE in India even if those contracts are not actually in the name of the foreign enterprise [*Galileo International Inc. (2008)(19 SOT 257)(Del Trib.)*, *Amadeus Global Travel Distribution S.A. (2011)(11 taxmann.com 153)(Del Trib.)*]

If an agent simply signs a contract after taking approval of its principal then no PE would be constituted [see *Sutron Corporation v. DIT (2004) (268 ITR 156) 8 (AAR)*]. Also in the case of *Western Union Financial Services Inc. v. Asstt. DIT (2006) (101 TTJ 56 9)(Delhi)* and *Morgan Stanley & Co. (supra)*, it has been observed that if an agent simply implements on source country the contracts which were concluded by the foreign principal outside the country, then no PE would be there in the form of an agent.

In *Al Nisr Publishing In re (1999)(237 ITR 877)(AAR)* it was held that if the advertisements are routed through an independent agent, there would not be a PE of the foreign company in India. The AAR in this case has brought out the distinction between an agent who may constitute a PE and one who may not. The recent decision of the Bombay High Court in the case of *B4U International Holdings Ltd. (2015) 57 taxmann.com 146)(Bom.)* has also upheld this view. However, in a subsequent decision of the Mumbai Tribunal in the case of *NGC Network Asia LLC (2015)(64 taxmann.com 289)(Mumbai - Trib.)*, the Mumbai Bench of Tribunal held that in view of fact that NGC habitually exercised in India an authority to conclude contracts on behalf of assessee and same was binding on assessee, it was rightly regarded as 'dependent agent' of assessee in terms of Article 5(4)(a) of India-USA DTAA.

A client relationship manager who advises merely as a broker to a client regarding certain shares, it cannot be said that such broker is also taking business decisions on behalf of the assessee. Even if the broker was giving certain advices, it would not make the broker a PE of the assessee [*Salil Sevantilal Shah (2011)(45 SOT 64)(Mum.)(URO)*].

In the case of *Morgan Stanley and Co. Inc. (supra)*, the Supreme Court held that a BPO rendering support services to foreign client of the US parent company for reconciliation, research, etc. does not result in agency PE of the US parent company in India as the Indian company did not have any authority to conclude contracts on behalf of the US parent company.

In the case of *Dun & Bradstreet, In re (2005)(142 TAXMAN 284)(AAR)*, the AAR observed that the Indian company could not be regarded as a branch/sales outlet of

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the applicant as it was evident from record that it was a separate legal entity. The AAR held that the transaction was more akin to sale by the applicant to the India Company rather than delegation of sale function to the Indian company and therefore it could not be said that the Indian company habitually maintained stock of goods on behalf of the applicant. The Indian company being an independent entity carried on its own business without any control/ instructions of the applicant. Therefore it could not be treated as an agent of the applicant. This decision of AAR has been relied upon subsequently by the High Court report in (2012(20 taxmann.com 695)(Bom).

The Co-ordinate Bench of the Delhi Tribunal in the case of *Western Union Financial Services Inc.* (2015)(64 taxmann.com 230)(Delhi - Trib.), held that the software was the property of the assessee and it had not parted with its copyright therein in favour of the agents. The agents had only been allowed the use of the software in order to gain access to the mainframe computers in the USA. Mere use of the software for the purpose from the premises of the agents could not lead to the decision that the premises-cum-software would be the PE of the assessee in India.

The Co-ordinate Bench further examined that the agents were appointed by assessee in the ordinary course of their business and their activities were not devoted wholly or almost wholly to the foreign enterprise and, further, the transactions were under arm's length price. Therefore, the agents were independent agents under Article 5(5) of the DTAA.

Recently, the Delhi High Court in the case of *National Petroleum Construction Company (supra)* held that where assessee, a UAE based company, in the course of carrying out contract with ONGC for installation of petroleum platforms, availed services of ASL for providing marketing information and other facilities in India, since 'ASL' was not authorised to conclude contract on assessee's behalf, Paragraph 5 of Article 5 of India-UAE DTAA applied to its case and, thus, it could not be regarded as dependent agent PE of the assessee in India

Paragraph 5(b) of the UN Model covers the cases where the agent is not covered in clause (a) i.e. it does not have an authority to conclude contracts on behalf of the enterprise; however, it maintains stock in the other Contracting State and delivers goods or merchandise out of that stock on behalf of the enterprise. As mentioned above, this clause is absent in the OECD Model Convention.

In a nutshell, if an agent habitually and independently enters into contracts with /without authority of his principal or habitually maintains and sells goods on behalf of the principal, such an agent would form a PE. Therefore, what is important is not only contractual authority but also authority which can be presumed from the conduct.

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As opposed to a dependent agent, an independent agent is one who acts in the ordinary course of the business independent of his principal.

Subsidiary PE - A subsidiary is specifically excluded from being considered as a PE. This is because the subsidiary is a separate legal entity. However, if the subsidiary acts and performs the same functions as an agent, then it may become a PE of the parent. Therefore, in certain circumstance it may be essential to pierce the corporate veil.

A question arises whether the dealings between a non-resident parent company and its Indian subsidiary can at all be regarded as on principal-to- principal basis since the former would be in a position to exercise control over the affairs of the latter. In such a case, if the transactions are actually on a principal-to-principal basis and at arm's length and the subsidiary company functions and carries on business on its own, instead of functioning as an agent of the parent company, the mere fact that the Indian company is a subsidiary of the non-resident company is not a valid ground for holding it to be a PE of the parent company. Thus, if the subsidiary and parents' transactions are on a principal-to-principal basis and the parent does not use its influence in the pricing policy in related party transaction, then the subsidiary would not be a PE.

In its landmark ruling in the case of *Vodafone International Holdings B.V. (2012) (17 taxmann.com 202)(SC)*, the Supreme Court laid down some of the principles in connection with parent-subsidiary relationship. These are briefly covered below:

- The Act, in the matter of corporate taxation, is founded on the principle of the independence of companies and other entities subject to income-tax;
- Companies and other entities are viewed as economic entities with legal independence vis-à-vis their shareholders/participants;
- It is fairly well accepted that a subsidiary and its parent are totally distinct taxpayers. Consequently, the entities subject to income-tax are taxed on profits derived by them on standalone basis, irrespective of their actual degree of economic independence and regardless of whether profits are reserved or distributed to the shareholders/participants;
- It is fairly well settled that for tax treaty purposes a subsidiary and its parent are also totally separate and distinct taxpayers;
- The fact that a parent company exercises shareholder's influence on its subsidiaries does not generally imply that the subsidiaries are to be deemed residents of the State in which the parent company resides;

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- Where the subsidiary's executive directors' competences are transferred to other persons/bodies or where their decision making has become fully subordinate to the Holding Company with the consequence that the subsidiary's executive directors are no more than puppets then the turning point in respect of the subsidiary's place of residence comes about;
- Similarly, if an actual controlling Non-Resident Enterprise makes an indirect transfer through "abuse of organisation form/legal form and without reasonable business purpose" which results in tax avoidance or avoidance of withholding tax, then the Revenue may disregard the form of the arrangement or the impugned action through use of Non-Resident Holding Company, re-characterize the equity transfer according to its economic substance and impose the tax on the actual controlling Non-Resident Enterprise;
- Thus, whether a transaction is used principally as a colourable device for the distribution of earnings, profits and gains, is determined by a review of all the facts and circumstances surrounding the transaction;
- It is in the above cases that the principle of lifting the corporate veil or the doctrine of substance over form or the concept of beneficial ownership or the concept of alter ego arises.

In the case of *Aramex International Logistics (P.) Ltd., In re (2012) (208 Taxman 355)(AAR)*, it was held that if a wholly owned Indian subsidiary company is created for the purpose of attending to the business of the group in India, the subsidiary must be taken to be a PE of the group in India.

However, subsequently, in a different fact pattern in the case of *Lubrizol Corporation USA (2013) (33 taxmann.com 424)(Mumbai - Trib.)*, the Mumbai Bench of the Tribunal held that where the Indian subsidiary only assisted in sale of products in India and did not have any authority to negotiate terms of sales or conclude a contract on behalf of the foreign assessee company, it could not be considered as an agency PE in India under Article 5 of DTAA between India and USA.

The Mumbai Bench of the Tribunal in the case of *DDIT v. Daimler Chrysler A.G. (2010) (39 SOT 418)(Mum)*, held that the Indian subsidiary would not constitute a place of management of the taxpayer in India as management of business of the foreign enterprise was by the Board of Directors at Germany and the foreign enterprise did not have a right to use the premises of the Indian Company and, therefore, it could not be treated as PE in India.

It was held in the case of *CIT v. Gulf Oil (Great Britain) Ltd. (1977) (108 ITR 874 (Bom))* that if in pursuance to the indents placed by the Indian subsidiary which are

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accepted outside India and the contracts are also executed outside India by putting goods on ships and there being no reservation of right of disposal of goods by the non-resident, these products are not merely supplied by the non-resident company to the Indian subsidiary but are actually sold to the Indian subsidiary at certain prices. What is charged by the non-resident to the Indian subsidiary is the price and the transactions are not of the nature that there is supply of goods by the non-resident company to its Indian subsidiary on the basis of any commission or otherwise or for any other similar consideration. The transactions are as between principal-to-principal and not as between principal and agent. Thus it cannot be regarded affecting the sales as an agent of the non-resident company.

In the case of *CIT v. United Breweries (1973) (89 ITR 17)(Mysore)*, the High Court held that in deciding whether a subsidiary company is an agent of the parent company, the true test is whether, in addition to capitalistic control, there is a functional control by the parent over its subsidiary. If the parent company did exercise functional control over its subsidiary, the corporate veil could be lifted and the existence of such subsidiary company as a separate legal entity would not prevent the business of the subsidiary being treated as that of the parent company. Two decisions of the English Courts, *Odhams Press Ltd. v. Cook ((1941) (9 ITR (Supp.) 92, 109, 106 (HL))* and *Smith, Stone and Knight Ltd. v. Lord, Mayor, Aldermen and Citizens of the City of Birmingham (1939) (4 All ER 116) (KB)* have been referred to by the Mysore High Court. While recognizing that the determination of whether a subsidiary carries on the business of the parent company would solely depend on the facts of each case, *Smith, Stone and Knight* (supra) laid down the following six tests in this regard:

- Were the profits of the subsidiary company treated as those of the parent company?
- Were the persons conducting the business appointed by the parent company?
- Was the parent company, the head and brain of the subsidiary company?
- Did the parent company govern the activities of the subsidiary company and decide on what should be done and what capital should be embarked on it?
- Were the profits made by the skill and direction of the parent company?
- Was the parent company in effectual and constant control?

These tests could be used as general guidelines in establishing whether a subsidiary would constitute a PE or not.

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The Special Bench of the Delhi Tribunal in the case of *Motorola Inc.* (supra) has dealt with a number of issues concerning taxation of non-residents engaged in telecommunication services which inter alia involved the issue whether the activities of the appellant taxpayers, on the facts of the case, would result into a business connection / PE in India, merely because the non-residents had wholly owned subsidiaries in India? The Special Bench observed that a wholly owned subsidiary of a non-resident in India would constitute its PE in India if, their mutual relationship leads to the distinction between these two corporate entities becoming blurred and a reasonable inference can be drawn that the subsidiary was a virtual projection of the suppliers in India.

In the landmark ruling in the case of *Morgan Stanley and Co. Inc.* (supra), the Supreme Court established key principles for the taxation of a PE. In this ruling, the Supreme Court observed that in order to decide whether a PE stood constituted, one has to undertake what is called as a functional and factual analysis of each of the activities to be undertaken by the establishment. In this backdrop, the Supreme Court held that carrying out of back office operations by the Indian subsidiary does not result in formation of PE for the US parent company engaged in front office operations.

In the case of *E-Funds IT Solution (2014) (42 taxmann.com 50)(Delhi)*, the High Court laid down broad principles on the Fixed base PE, Service PE, Agency PE and Subsidiary PE. The High Court in this case held that where an assessee does not have any branch office or factory or workshop in India and merely because it has a subsidiary in India, that by itself does not create a fixed place of business/location PE within the meaning of Article 5(2), sub-clauses (b) to (k) of India-US DTAA. It further held that Indian entity, i.e., subsidiary company, will not become location PE under Article 5(1) merely because there is interaction or cross transactions between Indian subsidiary and foreign Principal. [The Supreme Court has granted the Special Leave Petition against this order of the High Court vide Special Leave to Appeal (C) No. 30018 of 2014 & Others dated 10 August 2015 reported in (2015) (62 taxmann.com 214)(SC). Accordingly one needs to keep a watch on the final decision of the Supreme Court in this matter.]

As discussed above, there are various complications involved in establishing whether the non-resident is carrying on business through a PE or not. This is important to decide on the taxability of the non-resident. This Article on PE is one of the most important Articles in the DTAA. Though considering the way business has evolved, there are further complications in the context of digital economy. One would also need to keep a watch on the OECD BEPS Action Plans 1 and 7 dealing with

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“Addressing the tax challenges of the digital economy” and “Preventing the artificial avoidance of Permanent Establishment status”. This has been separately discussed in Chapter dealing with BEPS Actions plans.

5.11. Chapter III

Chapter III is also called the Distributive Rules as regards the computation of income, as it specifies how much revenue a State will receive from a particular source of income/activity. That determination is made by using expressions such as “shall be taxed only in” which means only one of the States has a right to tax that income or by using the expression “may be taxed in the State of Source but at a rate not exceeding..” which means that the income can be taxed by the source State at a limited rate.

The classification in the DTAA is important as the taxability of the income is to be considered under the appropriate classification only. If the income cannot be taxed under that head it cannot be forced into another head to bring it into the tax net [see *Horizontal drilling International v. CIT (1999) (103 Taxman 447)(AAR)*]. This advance ruling has been relied on by the Mumbai Bench of the Tribunal in the case of *Aditya Birla Nuvo Limited v. ADIT (2011)(44 SOT 601)*, wherein it is held that since the supervisory services were in the nature of business profits, it would not be covered under the FTS clause under the DTAA between India and Italy.

Chapter III – Article 7: Business Profits (Attribution Rule and Force of Attraction Rule)

Article 7 of the UN Model reads as under:

“ARTICLE 7 – Business Profits

1. *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. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*

2. *Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent*

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establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. *In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.*

4. *In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.*

5. *For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.*

6. *Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.*

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(NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

Para	OECD Model Convention	US Model Convention
1	More or less similar when paragraph 1 and 2 read conjointly	More or less similar when paragraph 1 and 2 read conjointly
2	Absent	Absent
3	Absent in OECD Model Convention	Absent
4	Absent in OECD Model Convention	Absent
5	Similar	Similar

Contains an additional paragraph as under:

5. In applying this Article, paragraph 8 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 5 of Article 12 (Royalties), paragraph 3 of Article 13 (Gains) and paragraph 3 of Article 21 (Other Income), any income, profit or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where such permanent establishment is situated even if the payments are deferred until such permanent establishment has ceased to exist.

This Article in very many ways is the crux and the raison d'être of the DTAA. The Article is basically divided into 6 paragraphs. These are briefly discussed as under:

Paragraph 1 stipulates that the profits can be taxed in the country of residence unless in operates through a PE in the other state. The State in which the business is carried on can tax the profits only when the business is carried on through a PE. The

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concept of PE has been elaborately discussed in the earlier Chapter. The profits that can be taxed are restricted to the profits which can be attributed to the PE. Thus, in essence, the taxability of business income of a foreign enterprise depends upon two main questions; firstly, whether the enterprise has a PE in the source state, and, secondly, if the answer to the first question is in affirmative, what are the profits that are attributable to the PE. For answer to the first question, reference has to be made to Article 5; and for the second question, one need to refer to Article 7.

Paragraph 2 stipulates that the PE should be considered as an independent unit for its transactions with the companies in the State in which it is located and also for its transactions with the foreign parent. This also has transfer pricing implications as it implies that the mark up or cost of transfer of goods and technology to the parent should be at the same price, as it would be to any other independent entity.

Paragraph 3 limits the deductions, which are allowable to a PE in the computation of its income. All the expenses incurred by the PE, in relation to its business in that State, (whether in the State or elsewhere) are allowed as a deduction. However, payments to Head Office, or other group companies, of royalties, etc. are not allowed, with the exception of reimbursement of actual expenses. (In the case of a Banking company, however, interest paid on moneys borrowed is allowed as a deduction.). These restrictions are to ensure that the profits are not artificially suppressed.

Generally, the profits of the PE are to be computed considering the provisions of the domestic tax law of the State in which it is situated. However, the UN Model Convention specifically lays down in Paragraph 3 of the Article, the manner in which the profits attributable to the PE are to be computed.

The AAR in the case of *AAR P. No. 13 of 1995 (1997)(228 ITR 487)* while dealing with the provision of the DTAA between India and France, observed that the words "in accordance with the provisions of and subject to the limitations of the taxation laws of the Contracting State" used in Article 7.3(a) of the DTAA would attract, in the computation of the profits under Article 7, the limitations and restrictions not merely of section 44C of the Act but also of all other provisions contained in the Act.

Paragraph 4 allows the source State to compute the profits by allocating the total profits of the enterprise to its various parts if it is customary for the source State to determine profits in such a manner.

Paragraph 5 lays down that the consistent method should be adopted from year to year in computing the profits of the PE.

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Paragraph 6 is an exclusion clause and emphasis that a Special Article would override a General Article. Therefore, royalties, interest which are dealt with independently in the DTAA would not be affected by the provisions of this Article.

As discussed above the important element in this Article is the PE. The underlying concept of Article 7 is that the profits of an enterprise of a Contracting State are not taxable in other Contracting State unless the enterprise carries on business in that other state through a PE situated therein. Article 7 has to be read in conjunction with Article 5. A PE is defined in Article 5 and the business profits are only taxable if there is a PE through which the business is carried on and only to that extent. This is popularly known as the 'attribution rule'. The purpose is to limit the taxable income to what is derived from that State. The UN and the OECD models follow this rule. The UN model however extends the scope by what is known as the 'force of attraction rule' which is discussed subsequently in this Chapter

What is essential is that there should be a business connection or PE which may give rise to income for the non-resident in the source State. The Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd v. DIT (2007)(158 Taxman 259)(SC)* observed as under:

"Whereas business connection is relevant for the purpose of application of section 9 under the Act; the concept of PE is relevant for assessing the income of a non-resident under the DTAA".

The concept of a PE can be said to be a fine-tuning of the concept of business connection, although the essence or motive of both the provisions is the same, i.e. taxing a foreign enterprise carrying on business activities in another country (source country), in respect of the profits earned in the source country by virtue of such business activities.

The distinction between the two concepts of PE and business connection has been explained in *AAR P No. 8 of 1995 In re (1997)(223 ITR 416)* which has placed reliance on the decision of the Supreme Court in the case of *R. D. Aggarwal and Co. (supra)*. It has been pointed out that a business connection under the Act implies some sort of continuity; whereas the criteria for determination of PE are specifically laid down in the treaty. The concept in domestic law of 'business connection' and that of 'PE' in the DTAA must merge for the purpose of taxation. The Supreme Court ruling in the case of *R.D. Aggarwal & Co. (supra)* elaborates on the expression "Business connection" by holding that the same postulates a real intimate relation between the trading activity carried on outside the taxable territories and the trading activity within the taxable territories, the relation between the two contributing to the

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earning of income by the non-resident in his trading activity. To conform the requirements of business connection, it is necessary that the common thread of mutual interest must pass through the fabric of the trading activities carried on outside and inside of the taxable territory and the same has been described as real and intimate connection. In *Carborandum Co. v. CIT (1977)(108 ITR 335)(SC)*, the Supreme Court considered whether making services of foreign technical personnel available to the Indian Company amounts to business connection. The Court held that it will not. The concept of "business connection" has been extended to an agent (dependent or independent under certain circumstances) of a non-resident, with an Explanation inserted by the Finance Act, 2003, w.e.f. 1 April, 2004 to section 9(1)(i) of the Act. With this extended meaning, the concept has now become at par with the PE under the DTAA's with slight variations.

The Andhra Pradesh High Court in the case of *G. V. K. Industries v. ITO (1997) (228 ITR 564)(AP)* has also elaborated on the meaning of business connection as under:

"From the above discussion the following principles emerge:

- (i) whether there is a business connection between an Indian company and a non-resident (company) is a mixed question of fact and law which has to be determined on the facts and circumstances of each case;*
- (ii) the expression 'business connection' is too wide to admit of any precise definition; however, it has some well known attributes:*
- (iii) the essence of 'business connection' is the existence of close, real, intimate relationship and commonness of interest between the NRC and the Indian person;*
- (iv) where there is control of management or finances or substantial holding of equity shares or sharing of profits by the NRC of the Indian person, the requirement of principle (iii) is fulfilled;*
- (v) to constitute 'business connection' there must be continuity of activity or operation of the NRC with the Indian party and a stray of isolated transaction is not enough to establish a business connection."*

The Supreme Court subsequently in this case observed that the conclusion of the High Court in regard to business connection is absolutely defensible reported in *(2015)(54 taxmann.com 347)(SC)*.

Thus, the presence of business connection is essential to bring the profit to tax in India. The erstwhile CBDT Circular No. 23 dated 23 July 1969 and the decision of the

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Supreme Court in the case of *R. D. Aggarwal and Co. (supra)* are the benchmarks to be used to understand the concept of business connection.

Business profits – ‘Profit’, simply put, is the result of carrying on trade i.e. total receipts minus total expenses. The term ‘business’ has been interpreted by various courts to establish what is included and when can an activity be said to be a business. If a professional carries on an organized activity that too would involve carrying on of a business. The term ‘business profit’ in the context of treaty law has to be given the same meaning as in the interpretation of the Act. However, a service rendered by a professional in his individual capacity would not fall under the Article dealing with business profits but would fall under the Article dealing with Independent professional services which is discussed subsequently in Chapter dealing with IPS. E.g. if a teacher gives tuition to each student individually, it is an independent exercise of a profession. However, if the teacher brings together other teachers and sets up a coaching class it is a business activity.

If the source of income is either the activity or an asset of the PE, the income therefrom will be taxable as business profit. However, income from royalty, shares, etc. if not connected with the assets or activity of the PE, would be taxed under the separate Articles.

In case of income like dividend, royalty, etc. it is relatively easy to identify whether it can be considered to be attributable to a PE or not. The real problem arises in case of composite contracts e.g. it may be a contract for the supply and the erection of the machinery. In that case can the contract be split up as ‘business income’ and FTS; if it is a composite contract the payment of salaries of the personnel cannot be separated from the payment of fee for erection and the composite receipt would be taxable as Business Income [see *Skoda Export v. Addl. CIT (1983)(143 ITR 452)(AP)*].

Attribution rule:

The basic requirement to bring the business profits to tax is that they should be capable of being attributable to the PE. Typically, the tax treaties and conventions are silent as to what are the profits that can be termed as ‘attributable to PE’. In this regard, it is pertinent to note the following passage from Klaus Vogel on Double Tax Conventions, quoted by the Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd. (supra)*:

“In contrast, the second sentence of Article 7(1) MC allows the State of the permanent establishment to tax only those profits which are economically attributable to the permanent establishment, i.e. those which result from the permanent

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establishment's activities, which arise economically from the business carried on by the permanent establishment..... As regards the profits made by the enterprise in the State of the permanent establishment, a distinction must always be made between those profits which result from the permanent establishment's activities and those made, without any inter- position of the permanent establishment, by the head office or any other part of the enterprise..... It is only when there is a connection with the permanent establishment that the State of the permanent establishment is entitled to impose tax."

Given the above, it is manifest that for profits to be treated as being attributable to a PE, such profits must arise economically from the business carried out by the PE and have a direct and proximate connection with the PE.

In this regard, the question to be asked is whether the enterprise is trading with the country on a regular basis. If yes, what is the establishment set up in India? If the income arises out of the business activity carried on in that State and if it can be attributed to the PE, it can be taxed in that State to the extent of the attribution.

The Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd. (supra)* further elaborated on the territorial nexus doctrine observing that income arising out of operation in more than one jurisdiction would have territorial nexus with each of the jurisdiction on actual basis. If that be so, it may not be correct to contend that the entire income 'accrues or arises' in each of the jurisdiction. Following observations of the Supreme Court in this context are quite apposite:

"In case, where different severable parts of the composite contract are performed in different places, the principle of apportionment can be applied, to determine which fiscal jurisdiction can tax that particular part of the transaction. This principle helps determine, where the territorial jurisdiction of a particular state lies, to determine its capacity to tax an event. Applying it to composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations."

The question of attribution of profits in case of a turnkey contract came up for adjudication before the Supreme Court in the case of *CIT vs Hyundai Heavy Industries Co. Ltd. (2007)(161 Taxman 191)(SC)*. In this case, the Korean based taxpayer supplied material from Korea to Indian customer and also undertook responsibility for its installation and commissioning in India under a separate contract. The tax authorities sought to tax the profits earned by the Korean company on offshore supplies, which the Supreme Court rejected. The Supreme Court ruled that the profits earned by Korean company on offshore supply cannot be attributed to the

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Indian installation PE as the same came into existence only after the sale transaction got completed. Attribution of the profits in the case of composite contracts has also been dealt with by the courts in the cases of *Linde AG, Linde Engineering Division* [2014] 44 *taxmann.com* 244 (Delhi), *POSCO Engineering & Construction Co. Ltd.* [2014] 42 *taxmann.com* 500 (Delhi - Trib.), etc.

Force of attraction rule:

The 'force of attraction' is as an extension of the 'Attribution rule'. The rule of force of attraction means all income arising from all sources in a country, where the foreign enterprise maintains a PE is subject to tax in that country irrespective of whether the said income is 'attributable to' the PE or not. Therefore, profits arising from transaction outside PE are also taxable. As per this rule, not only the profits attributable to the sale of goods by or of the PE but also the profit attributable to the sale of same or similar kind of goods is brought to tax and any other income from sources within that country are also regarded as income attributable to the PE. Thus the scope of taxable income is much wider. The rationale behind this is that if a foreign enterprise has a PE in a particular State, that State should get the right to tax all the income arising therein to the PE whether or not it has a connection with the business.

Most of the DTAA's entered into by India with other countries provide for taxation of business profits only so much as are attributable to the PE of the foreign enterprise in India. However, there are eight DTAA's entered into by India with UK, Singapore, Japan, China, Vietnam, Oman, Ukraine and Uzbekistan, which provide that the profits attributable to the PE have to be direct as well as indirect and thereby contains the force of attraction rule.

The Mumbai Bench of the Tribunal in the case of *Linklaters LLP (supra)*, dealt with the interpretation of the term 'indirectly attributable to the PE', as used in Article 7 of the India-UK DTAA. In this decision, the Tribunal observed that the basic principle underlying the force of attraction rule is that when an enterprise sets up a PE in another country, it brings itself within the fiscal jurisdiction of that another country to such a degree that such another country can properly tax all profits that the enterprise derives from that country, whether the transactions are routed and performed through the PE or not. The Tribunal, then, concluded that the connotations of 'profits indirectly attributable to PE' incorporate the force of attraction rule in the India-UK treaty. Thus, it was held by the Tribunal that the entire profits relating to services rendered by the taxpayer, whether in India or outside, in respect of Indian projects are taxable in India.

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However, while arriving at this conclusion, the Tribunal did not consider the provisions of clause (3) of Article 7 of the India-UK DTAA. Clause (3) of Article 7 clarifies that where a PE takes active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, that proportion of the profits of the enterprise arising out of those contracts which the contribution of the PE to those transactions bears to that of the enterprise as a whole, shall be treated as profits indirectly attributable to the PE.

It is also relevant to note that similar phraseology of 'profits indirectly attributable to the PE' as used in India-Japan Treaty was a subject matter of discussion before the Supreme Court in the case of *Ishikhwajima Harima Heavy Industries Ltd (supra)*. There the Supreme Court observed that for profits to be attributed directly or indirectly, the PE must be involved in the activity giving rise to the profits. Unfortunately, the Tribunal in the case of *Linklaters LLP (supra)* has not taken cognizance of these observations of the Supreme Court.

The UN Model generally favours the developing countries. Therefore, while the developing countries would be in favour of adopting the rule of 'force of attraction' the developed countries would generally be opposed to it. Most countries would limit the application of this rule to business profits covered by Article 7 and not extend it to income from royalties, interest etc., covered by separate Articles and also, not to profit which arise from activities carried on through an independent agent. The objection to this rule, by developed countries is that, income which is totally unrelated to the PE should not be taxed and furthermore this would create uncertainty in the minds of taxpayers. A compromise is generally reached by providing that only similar activities or sale of similar goods even if not carried out through the PE will be taxable. Business profits as generally understood do not include royalty, interest etc. unless they have in connection to the PE. Besides, this also adversely affects tax planning and leads to uncertainty regarding obligation and liability to tax in the other State of the foreign enterprise. Therefore, at the time of negotiating the DTAA a compromise is reached as to what can be considered attributable to the PE to restrict the taxability to income, other than business income, to the extent it can be attributed to the PE.

The arm's length principle - Paragraph 2 of Article 7 stipulates that the profits which can be attributed to the PE would be the profit it would have made if it not had any connection with the Head Office. Therefore, the PE is put as a stand-alone entity and the profits are computed at an arm's length as if it were an independent entity. This is an attempt to arrive at the market price and prevent the foreign company from

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artificially suppressing its profits by charging a higher mark-up on transfer of goods or a higher amount as royalty than what it would have normally charged to another domestic third party. This principle is to bring the non-resident at par with the resident taxpayers. However, as per the decision of *Linklaters LLP (supra)*, this fictional independence of the PE under Article 7(2) of the DTAA does not travel beyond the transactions with entities other than the general enterprise and the PEs belonging to the same general enterprise. Accordingly, the Tribunal held that for the purpose of computing income of the PE in respect of services rendered to the Indian clients, value of services rendered by such PE is not to be taken at the market value of such services in India but the price at which the UK firm had billed the Indian clients.

After determining the independent income of the PE, the profits are then to be computed under the normal provisions of the Act. However, if the DTAA provides for or disallows specific deductions, they must be considered in the computation of income. The other principles for the computation of Business profits under the Act would be equally applicable except where specifically modified by the DTAA. Though, one interesting question that arises is, whether the non-resident has to choose in totality if he wants to be assessed under the Act or the DTAA or whether the option can be exercised for each deduction being claimed. In other words, in respect of an allowance/expense, a deduction is allowed under the DTAA but not under the Act, can the deduction, in respect of that expense/allowance, be claimed under the DTAA whereas; in respect of another allowance/expense, the deduction for which is available under the Act, but not under the DTAA, can the deduction be claimed under the Act for that allowance/expense? Or is it necessary to choose either the Act or the DTAA in respect of both the allowances/expenses and compute the entire income under, either the Act or the DTAA? In the absence of judicial precedents on this issue, one may select the most optimum alternative for each expense/allowance.

The Supreme Court in the case of *Morgan Stanley and Co. Inc. (supra)* established key principles for the taxation of a PE and the attribution of income to such PE in India. The Supreme Court held that if the foreign enterprise has a PE in India and such PE has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise, in such cases nothing further would be left to be attributed to the PE. The Supreme Court further held that situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered.

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Thus, this decision by the Supreme Court has affirmed the interplay between the transfer pricing analysis and the exercise involved in the attribution of profits to the PE by holding that the data placed by the taxpayer in each case has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case.

In the context of attribution of profits in case of dependent agent in India, the observations of the Delhi Bench of Tribunal in the case of *Rolls Royce Plc. (2009) (34 SOT 508) (Delhi)* are relevant. The Tribunal after referring to the Supreme Court's observations in *Morgan Stanley (supra)* clarified that payment to dependent agent or affiliate, who also constitutes a PE, on an arm's length basis, would extinguish additional income attribution to the PE only if such payment takes into account the Functions, Asset and Risk of the Multinational Enterprise.

A little while before the case of Morgan Stanley was decided, the Mumbai Bench of Tribunal, in the case of *Set Satellite (Singapore) (Pte.) Ltd. (2007) (106 ITD 175) (Mum)*, noted an interesting observations on the subject. The relevant extracts of the judgment are as under:

*"The particular difficulty in the case of a dependent agent permanent establishment is that DAPE itself is hypothetical because there is no establishment - permanent or transient- of the GE in the PE state. **The hypothetical PE, therefore, must be visualized on the basis of presence of the GE as projected through the PE, which in turn depends on functions performed, assets used and risks assumed by the GE in respect of the business carried on through the PE.** The DAPE and DA has to be, therefore, be treated as two distinct taxable units."* (Emphasis supplied)

The above decision of the Tribunal when tested in the Bombay High Court reported in *(2008) (307 ITR 205) (Bom)*, the High Court observed that entire rationale and reasoning given by the Tribunal deserved to be set aside. The High Court, after referring to the case of *Morgan Stanley (supra)* noted that, if the correct arm's length price is applied and paid then nothing further would be left to be taxed in the hands of the Multinational enterprise. It also relied on the erstwhile Circular No. 23 dated 23 July, 1969 issued by the CBDT to support this. It may be noted that the Revenue is in appeal before the Supreme Court against this order of the Bombay High Court.

In the context of attribution of profits to a PE, a few issues that may generally arise in India in the computation of business profits are briefly covered below:

Presumptive rate of taxation - The Act provides a presumptive method of taxation in the case of certain activities i.e. shipping, oil exploration, etc undertaken by non-

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resident. If the non-resident is engaged in one of these activities, an issue may arise whether it is necessary to apply the deemed rate of profit as provided under the Act or should the income be computed under the provisions of the Act read with the DTAA. The decision of the AAR in the case of *N.V. Jan de Nul (1999)(236 ITR 489)* seems to suggest that section 44BBB is mandatory. However the Act w.e.f. 1.4.2004 provides an option to the taxpayer to choose to be assessed under the normal provisions or under section 44BBB as is more beneficial. Accordingly, this may not be such a controversial issue any more.

Accounting principles for a PE – A foreign company is required to maintain its books of account relating to the Indian business in the manner provided in sections 128 and 129 of the Companies Act, 2013. The accounts must be drawn in Indian rupees. The Supreme Court observed in the case of *Hyundai Heavy Industries Co. Ltd. (supra)* that the profits attributable to the PE are required to be computed under the normal accounting rules.

Taxes paid on behalf of the non-resident - At times, based on business considerations, the resident may agree to bear the tax payable by a non-resident. The position in law seems to be that the tax liability agreed to be borne has to be grossed up for the purpose of deduction of tax at source. However, the entire tax borne cannot be considered to be the income of the non-resident. In the case of *CIT v. Schlumberger Sea Co. Inc. (2003)(264 ITR 331)(Mad)*, the Madras High Court found that the entire tax borne cannot be included as the presumptive income of the recipient and that only 10 percent of such tax should be so included because the tax has the same character as the income itself.

Head office expenditure - The DTAA would normally provide for a deduction of the actual expenses incurred. However if the domestic law puts a ceiling on those expenses, the ceiling would apply. E.g. in India provisions of section 44C of the Act would have to be considered. The DTAA also normally does not distinguish between expenditure directly or indirectly related to the PE. If, an expense incurred by the Head Office, indirectly has some benefit for the PE, it is allowable. The provisions of the local laws would also have to be seen in this connection. If the expenses relate only to the branch, they are to be allowed in full [see *CIT v. Emirates Commercial Bank Ltd (2003)(262 ITR 55)*]. It has also been held in the case of *American Bureau of Shipping v. CIT (263 ITR 590)(Bom.)* that where there is no income the Head Office expenses cannot be disallowed to arrive at the taxable income.

In the case of *CIT v. Bank of America NT & SA (2003)(262 ITR 504)*, the question arose as to whether the Head Office expense should be on an average basis or an

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actual basis where the expenses are identifiable. It was held that the *ad-hoc* allowance provided in the Branch Books could not be considered and it is only the average Head Office expense that should be allowed and not the *ad-hoc* allowance as Head Office expense.

The above paragraphs, elaborately discuss the concept of profit attribution in case of PE under the existing DTAAs. However, the BEPS in its Action Plan 7 dealing with “Preventing the Artificial Avoidance of Permanent Establishment Status”, has addressed the issue on profits attribution. The committee has come up with additional guidance on the issue of attribution of profits to PEs in March 2018. This has been separately discussed in Chapter dealing with BEPS Actions plans.

5.12. Chapter III – Article 9: Associated Enterprises (AE)

Article 9 of UN Model reads as under:

“1. Where:

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

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3. *The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.*"

Para	OECD Model Convention	US Model Convention
1	Similar	Similar
2	Similar	Similar
3	Absent	Absent

The concept and definition of Associated Enterprises (AE) was introduced in the DTAAs to prevent misuse of treaty provisions by conducting business in the State not directly but through a chain of enterprises. This Article provides that where an enterprise has control directly or indirectly on another enterprise either through the management or the capital of that enterprise and if the transactions between the two enterprises are not at market rates, then the profit which would have accrued at arm's length to the enterprise supplying goods/services will be deemed to be the income of that enterprise. Here again the concept of effective management (discussed earlier) has relevance. It is not necessary that the control should have a legal blessing, but that it should be evidenced by conduct. The ratio behind this Article is to ensure that profits are computed on an arm's length basis and are not artificially enhanced or suppressed to enhance relief or reduce liability.

This Article allows the Tax Authorities to compute the fair profit on a transaction between two AE. However, this should not be presumed to be a mandatory right. Only where there is reason to believe that the profit has been maneuvered with, should the tax authorities interfere. However, care should be taken that the income finally computed does not exceed the real income and that the manner of computation is within the spirit of the convention and the Transfer Pricing Rules in each country. Therefore, what is now really required is some kind of standardization on Transfer Pricing Rules universally to ensure that too much divergence of practice is avoided. Imagine a case where each country's Assessing Officer computed the income on his belief of what should be the fair profit of the enterprise. This would be unfair and would also cause a lot of confusion in the minds of the taxpayers. No country should assume that this is a blanket permission to rewrite the accounts in respect of the transactions which take place in its jurisdiction.

This principle that avoidance or reduction of tax liability by routing it through an AE should be avoided is also recognized in the detailed transfer pricing provisions

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introduced in the Act by the Finance Act, 2001, which amended the Act. (Sections 92 – 92F). The provisions are more or less in line with international transfer pricing provisions. The central theme of the provisions is the arm's-length principle, which requires charging of an arm's-length price for all international transactions between AEs, supported by appropriate documentation. The term "international transaction" is defined in section 92B and "transaction" is defined in section 92F(5). An "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. The Finance (No. 2) Act, 2015 has also amended the concept of "deemed international transaction", where subject to certain conditions a transaction between 2 independent local entities may also be considered as an international transaction and would be subject to Transfer Pricing regulations in India. According to section 92(B)(2), a transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be an international transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not. Therefore, all transactions which are likely to have an impact on the profits of the enterprise are meant to be captured. Further, section 92F(v) defines a "transaction" to include an arrangement, understanding or action in concert, - (a) whether or not such arrangement, understanding or action is formal or in writing; or (b) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

One more key amendment to the transfer pricing provisions under the Act is introduction of the Advance Pricing Agreement ('APA') by the Finance Act, 2012. APA is an agreement between the CBDT and the tax payer, which determines, in advance, the arm's length price or specifies the manner of the determination of the arm's length price(or both), in relation to an international transaction. Once an arm's length price has been entered into with respect to an international transaction, the

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price will be determined only in accordance with the APA. It should be binding on the person and the Commissioner of Income-tax and his subordinates having jurisdiction over such person or transaction.

Association - Whether two enterprises can be considered as associated would depend on the facts of each case. The connection between the enterprises has to be understood and the commonality of management and capital has to be seen. All that given, if the two enterprises are acting in their independent capacity and do not influence each other they cannot be considered as AE provided also that the transaction was at arm's length. However, the commonality of management would lend a presumption among the tax authorities that there is scope to maneuver the profit and the enterprise would have to prove otherwise. If the two enterprises are deemed to be AE, the arm's length profit will have to be arrived at i.e. the profit it would have otherwise earned as in a transaction with an unrelated party.

In the context of Indian transfer pricing provisions, the term "Associated Enterprise" has been defined in section 92A(1) of the Act in an exhaustive manner, the underlying emphasis being on inter dependence. The dependence may be for supply of raw material or provision of services or marketing dependence, to specifically mean all enterprises, which are associated due to some common thread of management or control or capital. Any transaction between related enterprises has to be at an "arm's length price". The methods for computation of "arm's length price" have also been prescribed in the Act. These methods and the term "associated enterprise" have been explained in detail in the Chapter on Transfer Pricing.

One issue that arises is on the treatment in the other country of the profits adjusted by the first country. Though this is a very practical problem, it has not been dealt with in the DTAA. The ratio seems to be that the adjustment made by one State cannot be superimposed on the other State either to its advantage or disadvantage.

This Article is an extension of the arm's length principle contemplated in Article 7. Paragraph 1 - This paragraph specifies when two undertakings can be deemed to be AE and allows adjustment to profits to arrive at the arm's length profit if the conduct of the AEs shows that the profits have been understated. Therefore even if assets are transferred but if the parties continue to enjoy the income therefrom on account of their control over the asset or any other reason the income could be taxed in their hands.

In *M.Ct.M. Chidambaram Chettiar v. CIT (1966) (60 ITR 28)(SC)* it was found that as the partners had the right to continue enjoying the asset, on account of their controlling interest in the transferee non-resident company the tax therefrom could be

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levied on them. This decision although rendered in the context of section 44D of the Act, its ratio may still be applicable to understand when the AO has the authority to make adjustments to the profits as the object of section 44D is also to prevent tax evasion. However, these provisions are not applicable in the case of *bona fide* commercial transactions.

Paragraph 2 - This may sometimes result in double taxation of the same profits; once in the country where they are artificially shifted and once again in the country where they actually arise. Paragraph 2 aims at preventing double taxation by allowing the former State to provide relief. The important words to note in this article are “profits which...have not so accrued ...”. What is essential is that profit must have accrued. Where no profit accrues whether or not the enterprises are associated, it will have no relevance. The adjustment made in one country must be given corresponding effect in the other country. But no automatic authorization is given as one country cannot dictate terms to another country. In India, the current transfer pricing provisions do not permit such adjustments. However, keeping in mind that the object of the DTAA is to prevent double taxation, there should be some provision for such adjustments.

5.13. Chapter III - Article 10: Dividend

Article 10 of UN Model reads as under:

“1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

(a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganization, of the company that holds the shares or that pays the dividend) ;

(b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

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This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.”

Para	OECD Model Convention
1	Similar
2	<ul style="list-style-type: none"> • Rate of 5 percent is prescribed where beneficial owner holds directly or indirectly at least 25 percent of the capital of the company paying dividend • In other cases, rate of 15% is prescribed
3	Similar
4	Also includes independent personal services from a fixed base situated in the other contracting state as covered under Article 14
5	Also includes independent personal services from a fixed base situated in the other contracting state as covered under Article 14

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While the UN and OECD Model convention provide for more or less similar language of this Article, the US Model convention provide for a very wide coverage as under:

“1. Dividends paid by a company that is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that Contracting State, but if the beneficial owner of the dividends is a resident of the other Contracting State, except as otherwise provided, the tax so charged shall not exceed:

- a) 5 percent of the gross amount of the dividends if, for the twelve-month period ending on the date on which the entitlement to the dividends is determined:*
 - i) the beneficial owner has been a company that was a resident of the other Contracting State or of a qualifying third state. The term “qualifying third state” means a state that has in effect a comprehensive convention for the avoidance of double taxation with the Contracting State of the company paying the dividends that would have allowed the beneficial owner to benefit from a rate of tax on dividends that is less than or equal to 5 percent; and*
 - ii) at least 10 percent of the aggregate vote and value of the shares of the payor of the dividends was owned directly by the beneficial owner or a qualifying predecessor owner. The term “qualifying predecessor owner” means a company from which the beneficial owner acquired the shares of the payor of the dividends, but only if such company was, at the time the shares were acquired, a connected person with respect to the beneficial owner of the dividend, and a resident of a state that has in effect a comprehensive convention for the avoidance of double taxation with the Contracting State of the company paying the dividends that would have allowed such company to benefit from a rate of tax on dividends that is less than or equal to 5 percent. For this purpose, a company that is a resident of a Contracting State shall be considered to own directly the shares owned by an entity that:*
 - A) is considered fiscally transparent under the laws of that Contracting State; and*
 - B) is not a resident of the other Contracting State of which the company paying the dividends is a resident;*
- in proportion to the company’s ownership interest in that entity; and*
- b) 15 percent of the gross amount of the dividends in all other cases.*

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This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. Notwithstanding the provisions of paragraph 2 of this Article, dividends shall not be taxed in the Contracting State of which the company paying the dividends is a resident if:

- a) the beneficial owner of the dividends is a pension fund that is a resident of the other Contracting State; and*
- b) such dividends are not derived from the carrying on of a trade or business by the pension fund or through a person that is a connected person with respect to the pension fund.*

4. a) Subparagraph (a) of paragraph 2 of this Article shall not apply in the case of dividends paid by a U.S. Regulated Investment Company (RIC) or a U.S. Real Estate Investment Trust (REIT). In the case of dividends paid by a RIC, subparagraph (b) of paragraph 2 and paragraph 3 of this Article shall apply. In the case of dividends paid by a REIT, subparagraph (b) of paragraph 2 and paragraph 3 of this Article shall apply only if:

- i) the beneficial owner of the dividends is an individual or pension fund, in either case holding an interest of not more than 10 percent in the REIT;*
- ii) the dividends are paid with respect to a class of shares that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's shares;*
or
- iii) the beneficial owner of the dividends is a person holding an interest of not more than 10 percent in the REIT and the REIT is diversified.*

b) For purposes of this paragraph, a REIT shall be "diversified" if the value of no single interest in real property (immovable property) exceeds 10 percent of its total interests in real property (immovable property). For the purposes of this rule, foreclosure property shall not be considered an interest in real property (immovable property). Where a REIT holds an interest in a partnership, it shall be treated as owning directly a proportion of the partnership's interests in real property (immovable property) corresponding to its interest in the partnership.

5. In the case of the United States, notwithstanding the provisions of paragraph 2 of this Article, dividends paid by an expatriated entity and beneficially owned by a company resident in _____ that is a connected person with respect to such

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expatriated entity may be taxed in accordance with the law of the United States for a period of ten years beginning on the date on which the acquisition of the domestic entity is completed. For purposes of applying this paragraph:

- a) *no effect shall be given to any amendment to section 7874 of the Internal Revenue Code after the date of signature of this Convention; and*
- b) *no entity shall be treated as an expatriated entity that:*
 - i) *is a connected person with respect to the domestic entity immediately after the date on which the acquisition of the domestic entity is completed; and*
 - ii) *prior to that date, was never a connected person with respect to the domestic entity.*

However, an entity described in the preceding sentence shall become an expatriated entity if, subsequent to the date on which the acquisition of the domestic entity is completed, the entity joins in filing a U.S. consolidated return with either the domestic entity or another entity that was a connected person with respect to the domestic entity immediately prior to the date on which the acquisition of the domestic entity was completed.

6. Notwithstanding the provisions of paragraphs 1 and 2 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) regarding a dividend, if such company fails to satisfy the criteria of that paragraph solely by reason of:

- a) *the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention; or*
- b) *the requirement in clause (ii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) that a person entitled to benefits under paragraph 5 of Article 22 (Limitation on Benefits) would be entitled to a rate of tax with respect to the dividend that is less than or equal to the rate applicable under paragraph 2 of this Article;*

such company may be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirements referred to in subparagraphs (a) and (b) of this paragraph) would have

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been entitled if such persons had received the dividend directly. For purposes of this paragraph, (i) such persons' indirect ownership of the shares of the company paying the dividends shall be treated as direct ownership, and (ii) a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the dividends.

7. For purposes of this Article, the term "dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subject to the same taxation treatment as income from shares under the laws of the Contracting State of which the company making the distribution is a resident. The term does not include distributions that are treated as gain under the laws of the Contracting State of which the company making the distribution is a resident. In such case, the provisions of Article 13 (Gains) shall apply.

8. The provisions of paragraphs 1 through 6 of this Article shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.

9. A Contracting State may not impose any tax on dividends paid by a resident of the other Contracting State, except insofar as the dividends are paid to a resident of the first-mentioned Contracting State or the dividends are attributable to a permanent establishment situated therein, nor may it impose tax on a corporation's undistributed profits, except as provided in paragraph 10 of this Article, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that Contracting State.

10. a) A company that is a resident of one of the Contracting States and that has a permanent establishment in the other Contracting State or that is subject to tax in the other Contracting State on a net basis on its income that may be taxed in the other Contracting State under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains) may be subject in that other Contracting State to a tax in addition to the tax allowable under the other provisions of this Convention.

b) Such tax, however, may be imposed:

i) on only the portion of the business profits of the company attributable to the permanent establishment and the portion of the income referred

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to in subparagraph (a) of this paragraph that is subject to tax under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains) that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, in the case of _____, is an amount that is analogous to the dividend equivalent amount; and

- ii) at a rate not in excess of the rate specified in subparagraph (a) of paragraph 2 or paragraph 6 of this Article, but only if for the twelve-month period ending on the date on which the entitlement to the dividend equivalent amount is determined, the company has been a resident of the other Contracting State or of a qualifying third state. The term "qualifying third state" has the same meaning as in clause (i) of subparagraph (a) of paragraph 2 of this Article."*

For the purpose of ensuing paragraphs, the UN Model Convention and OECD Model Convention has been taken as base.

Paragraphs 1 to 3 - As we have seen so far, there is always a conflict between the source State and the resident State on the levy and collection of taxes. With income like dividends the agreement is that the income should be taxed in the State in which the profit arises. However, a compromise is normally reached on the rate of tax and with the source State retaining the right to tax. The dividend is taxed at different rates; normally between five to ten percent. The Article itself defines dividend. In different countries it may mean to include different things under the domestic law. Most of the DTAA's that India has negotiated would also include 'deemed dividends' as defined in section 2(22) of the Act. The intention behind giving it a broad definition is to cover all arrangements that give a return on equity investment.

Paragraph 4 normally provides that if the dividend income can be attributed to or is connected to a PE or a fixed base, then the income will have to be taxed under Article 7 which deals with business profits or the Article dealing with IPS. This may also be related to the principle of "force of attraction" which we discussed earlier.

Paragraph 5 lays down that the other State has no right to tax the dividend by a company registered in the first State unless paid to a resident of the other State. Similarly, the other State also does not have the right to tax the undistributed profits of the company registered in the first State. This clause also gives the country where the PE is situated or from where the business is carried on, the right to tax the dividend income.

Therefore, India would not only get the right to tax dividends as normally understood i.e. a share in the profits but would also get the right to tax any kind of distribution of

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profits, i.e. whether on reduction of share capital or liquidation, or any distribution by way of loan or advance to a substantial shareholder which may be treated as dividend.

Further, the withholding tax for dividend with few major countries is as mentioned in **Annexure A**.

The next issue that arises is whether gross or net dividend should be taxed. The Board Circular No. 369 dated 17 September 1983 (1984)(145 ITR (ST) 9) states that only gross dividend is assessable and it is the gross dividend which is to be considered as the doubly taxed income and should be taxed accordingly. This Circular is a result of the decision of the Kerala High Court in the case of *CIT v. N.S. Hobbs* (1979)(116 ITR 20 (Ker)) which held that net dividend is taxable and the decision of the Supreme Court in *CIT v. Clive Insurance Co. Ltd.* [1978](113 ITR 636)(SC) which held that income in respect of which tax has been paid in the foreign country will have to be treated as doubly taxed income. There have been conflicting decisions on this issue with the Madras High Court taking a view in the case of *A. F. W. Low v. CIT* (1995)(211 ITR 213)(Mad) and *CIT v. Amalgamations Ltd.* [1999] (103 Taxman 42) that it is the net dividend which is taxable, as credit cannot be given for foreign taxes though it is the gross dividend which accrues to the resident. The Calcutta High Court in the case of *CIT v. Oriental Co. Ltd.* (1982) (137 ITR 777)(Cal) has taken a view that it is the net dividend which would be treated as taxable income. The decision of the Kerala High Court in the case of *N.S.Hobbs* referred to earlier has been followed in the case of *CIT v. Ambalal Kilachand* (1994)(210 ITR 844) and Calcutta High Court in the case of *CIT v. Shaw Wallace & Co. Ltd.* (1981)(132 ITR 466).

However, the liberal view seems to be that tax deducted at source in foreign country for which no credit is possible in India should not form part of income taxable in India. Therefore, only net dividend ought to be taxed and foreign tax which is not refundable should not be considered, as the doubly taxed income is only the net income. Nonetheless, where the tax deducted at source on dividend is refunded by the source country, the gross dividend may be taxed. Till the enactment of Finance Act, 2016, this whole controversy was avoided in view of the fact that dividend was exempt under the Act upon payment of dividend distribution tax by the company. However, the Finance Act, 2016 has introduced a tax at the rate of 10% on dividends received by an individual, HUF or a firm resident in India from a domestic company in excess of INR 10 Lacs. However, as this amendment pertains only with respect to residents, it ought not impact the positions vis-à-vis non-residents. This also avoids getting into the controversy of whether dividend is taxable as business income or; as

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income from other sources. The extent to which deemed dividend may be taxed; however, is a matter of how the DTAA is worded i.e. whether the domestic law is fully imposed on the DTAA or, the definition in one of the Models is considered.

Both the OECD and the UN Model refer to the beneficial ownership which is mostly measured in terms of the voting rights to get over the difficulty of whether the paid up or issued capital including borrowing or preference or equity capital should be considered. This is to prevent residents of a third State from setting up corporates in the source State to get the benefit of the DTAA which they themselves may not have been entitled to. The important point here is that the dividend declared by a resident company is taxed. Dividends declared by a company which is not a resident cannot be taxed simply because some profit out of which the dividend is paid was earned/ originated in the other State. The benefit of the reduced rate of tax is to give the benefit to the real owners by giving recognition to substance over form and to discourage treaty shopping and tax evasion. The intention being to give the benefit of the DTAA to the person who has a real and sufficient nexus with the source State and the arrangement between two companies only to avail the reduced rate of tax ought to be disregarded. (Refer AAR No. P-10 of 96 and AAR No.P of 1995, (224 ITR 473)).

The definition of dividend in the model commentary as seen earlier can be classified as 'regular dividend', 'other rights not being debt claims', 'income from other corporate rights which is taxed in the same way as dividends'. Deemed dividend may fall into the last category. However, depending on how the Article is worded, it may be possible to contend that income from debt claims is covered and not the claim itself and therefore loans given may not be covered. This concept of deemed dividend is also recognized globally to bring disguised distribution of profits into the tax net. In fact, even the OECD commentary on the UN Model recognizes the same principles based on section 2(22). Therefore, any distribution of profits whether from current or accumulated, would be considered as dividends. However, the extent to which it can be deemed to be dividend would depend on the local laws.

At the core of all these issues is the fundamental debate on the justification of taxing dividend income. Dividend is distributed out of profits of a company which have already suffered tax, when they are taxed in the hands of the shareholder. In a way, the same income is being taxed twice. Recognizing this economic double taxation, India has exempted dividend. With respect to the amendment by the Finance Act, 2016 taxing the dividends declared by a resident company in excess of INR 10 lakhs in the hands of the residents at the rate of 10% may not affect the impact in the hands of the non-residents. However, since the liability gets shifted to the company

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which pays tax on the dividend declared at the prescribed rates, the ultimate objective, if it were so, to impose a single levy tax on dividend, is achieved or not is doubtful

In fact, this argument is also stretched to capital gains on shares. The increase in value represents the intrinsic value which is represented by the net worth of the company which is formed from taxed retained earnings. In fact, the constitutional validity of capital gains tax raised a huge hue and cry when introduced. However, the need for increasing revenue gathering prevails over economic justification. To a certain extent it can all be traced to *Mrs. Bacha F. Guzdar v. CIT (1955)(27 ITR 1)(SC)* which held that the character of income in the hands of the shareholders is different from that of the company.

Take a case of a foreign company having a subsidiary in India. The dividend declared by the subsidiary as well as the income of the subsidiary is clubbed into the parent's profits. These have already suffered tax in the source country and will again be subjected to tax in the country of residence of the parent. This is a good example to justify the validity of exempting dividends in the hands of the shareholders to bring down the effective rate of tax in the hands of the parent company at the rate at which tax is withheld at source in countries where dividend is not exempt. Another incentive to keep the rate of tax low is to attract and facilitate flow of capital. The benefit of this lower rate is given to persons who are the "beneficial owners" i.e. the persons who are the real recipient of the income as discussed above.

Article 8 of the MLI has been introduced for taxation of dividend. As per the provisions of Article 8(1) of the MLI –

*(1) Provisions of a Covered Tax Agreement that exempt dividends paid by a company which is a resident of a Contracting Jurisdiction from tax or that limit the rate at which such dividends may be taxed, provided that **the beneficial owner or the recipient** is a company which is a resident of the other Contracting Jurisdiction and which owns, holds or controls **more than a certain amount** of the capital, shares, stock, voting power, voting rights or similar ownership interests of the company paying the dividends, shall apply only if the ownership conditions described in those provisions are met throughout a 365 day period that includes the day of the payment of the dividends (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividends).*

Article 8 seeks to modify provisions of a CTA which limit the rate of tax levied in the country of 'source' on payment of dividends ("Treaty Relief"). However, as per the

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existing provisions, such Treaty Relief can only be claimed if the recipient of dividend is a 'beneficial owner' ("BO Test"). In some treaties, the BO Test is a subjective one whereas in others, the objective criteria for BO Test is specified, for example, if the recipient holds a certain percentage of shares in the company paying the dividends etc. As is evident, the BO Test exists to prevent base erosion by ensuring that only in case of receipt of dividends by beneficial owners, can the dividends be exempt from tax in the country of 'source.' That said, manipulative measures led to a lot of taxpayers misusing this provision. In order to plug the loopholes and strengthen the BO Test, Article 8, which is based on Article 10(2) of the OECD Model Convention as amended by Action 6 Report seeks to introduce a minimum holding period of 365 days throughout which the BO Test should have been satisfied for the Treaty Relief to apply ("Testing Period"). The Testing Period is sought to be introduced through the application of Para 1 of Article 8.

The intention of the provision is to merely introduce the Testing Period without modifying the substantial allocation of taxing rights and other conditions under existing provisions, such as tax rates, ownership thresholds, form of ownership etc.

5.14. Chapter III – Article 11: Interest

Article 11 of UN Model reads as under:

ARTICLE 11 – Interest

"1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

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4. *The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.*

5. *Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.*

6. *Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention”.*

Para	OECD Model Convention
1	Similar
2	Rate of 10 percent is prescribed
3	Similar
4	Also covers cases where debt claim in respect of which the interest arises through provision of independent personal services from a fixed base situated in the other contracting state as covered under Article 14. Also covers cases where debt claim in respect of which the interest is paid is effectively connected with business activities referred to in (c) of paragraph 1 of Article 7

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5	Also includes independent personal services from a fixed base situated in the other contracting state as covered under Article 14
6	Similar

While the UN and OECD Model convention provide for more or less similar language of this Article, the US Model convention provide for a very wide coverage as under:

“1. Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other Contracting State.

2. Notwithstanding the provisions of paragraph 1 of this Article:

- a) interest arising in _____ that is determined with reference to receipts, sales, income, profits or other cash flow of the debtor or a connected person with respect to the debtor, to any change in the value of any property of the debtor or a connected person with respect to the debtor or to any dividend, partnership distribution or similar payment made by the debtor or a connected person with respect to the debtor may be taxed in _____, and according to the laws of _____, but if the beneficial owner is a resident of the United States, the interest may be taxed at a rate not exceeding 15 percent of the gross amount of the interest;*
- b) interest arising in the United States that is contingent interest of a type that does not qualify as portfolio interest under the law of the United States may be taxed by the United States, but if the beneficial owner is a resident of _____, the interest may be taxed at a rate not exceeding 15 percent of the gross amount of the interest;*
- c) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payor of the interest may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to such interest in its Contracting State of residence;*
- d) in the case of the United States, interest paid by an expatriated entity and beneficially owned by a company resident in _____ that is a connected person with respect to such expatriated entity may be taxed in accordance with the law of the United States for a period of ten*

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years beginning on the date on which the acquisition of the domestic entity is completed. For purposes of applying this paragraph:

- i) no effect shall be given to any amendment to section 7874 of the Internal Revenue Code after the date of signature of this Convention; and*
- ii) no entity shall be treated as an expatriated entity that:
 - A) is a connected person with respect to the domestic entity immediately after the date on which the acquisition of the domestic entity is completed; and*
 - B) prior to that date, was never a connected person with respect to the domestic entity.**

However, an entity described in the preceding sentence shall become an expatriated entity if, subsequent to the date on which the acquisition of the domestic entity is completed, the entity joins in filing a U.S. consolidated return with either the domestic entity or another entity that was a connected person with respect to the domestic entity immediately prior to the date on which the acquisition of the domestic entity was completed;

- e) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payor of the interest may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits, at any time during the taxable year in which the interest is paid, from notional deductions with respect to amounts that the Contracting State of which the beneficial owner is resident treats as equity;*
- f) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is entitled to the benefits of this Article only by reason of paragraph 5 of Article 22 (Limitation on Benefits) may be taxed in the first-mentioned Contracting State, but the tax so charged shall not exceed 10 percent of the gross amount of the interest; and*
- g) interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit may be taxed by each Contracting State in accordance with its domestic law.*

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3 *Notwithstanding the provisions of paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) of this Convention regarding a payment of interest, if such company fails to satisfy the criteria of that paragraph solely by reason of:*

- a) *the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention; or*
- b) *the requirement in clause (ii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) that a person entitled to benefits under paragraph 5 of Article 22 (Limitation on Benefits) would be entitled to a rate of tax with respect to the interest that is less than or equal to the rate applicable under paragraph 2 of this Article;*

such company may be taxed by the Contracting State in which the interest arises according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirements referred to in subparagraphs (a) and (b) of this paragraph) would have been entitled if such persons had received the interest directly. For purposes of this paragraph, a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the interest.

4. *The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds or debentures, and all other income that is subjected to the same taxation treatment as income from money lent under the law of the Contracting State in which the income arises. Income dealt with in Article 10 (Dividends) and penalty charges for late payment shall not be regarded as interest for the purposes of this Convention.*

5. *The provisions of paragraphs 1 through 3 of this Article shall not apply if the beneficial owner of the interest, being a resident of a Contracting State,*

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carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.

6. For purposes of this Article, interest shall be deemed to arise in a Contracting State when the payor is a resident of that Contracting State. Where, however, the person paying the interest, whether a resident of a Contracting State or not, has in a Contracting State a permanent establishment or derives profits that are taxable on a net basis in a Contracting State under paragraph 5 of Article 6 (Income from Real Property (Immovable Property)) or paragraph 1 of Article 13 (Gains), and such interest is borne by such permanent establishment or allocable to such profits, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment is situated or from which such profits are derived.

7. The excess, if any, of the amount of interest allocable to the profits of a company resident in a Contracting State that are:

- a) attributable to a permanent establishment in the other Contracting State (including gains under paragraph 3 of Article 13 (Gains)); or*
- b) subject to tax in the other Contracting State under Article 6 (Income from Real Property (Immovable Property)) or paragraph 1 of Article 13 (Gains);*

over the interest paid by that permanent establishment, or in the case of profits subject to tax under Article 6 (Income from Real Property (Immovable Property)) or paragraph 1 of Article 13 (Gains), over the interest paid by that company, shall be deemed to arise in that other Contracting State and to be beneficially owned by a resident of the first-mentioned Contracting State. The tax imposed under this Article on such interest shall not exceed the rates provided in paragraphs 1 through 3 of this Article.

8. Where, by reason of a special relationship between the payor and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount that would have been agreed upon by the payor and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of

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each Contracting State, due regard being had to the other provisions of this Convention.”

For the purpose of ensuing paragraphs, the UN Model Convention and OECD Model Convention has been taken as base.

Paragraph 1 gives the State of which the person receiving the dividend is a resident the right to tax it. Here again, there is a tussle between the source State and the resident State for the right to tax the income. The resident State is given the right in Paragraph 1; but the words used are “may”. This paragraph has to be read in conjunction with Paragraph 2 which gives the source State the right to tax the income.

Paragraph 2 permits the source country to also tax the income to a certain extent. The bargaining power of the country would again establish the rate of tax. The OECD Model Convention prescribes 10 percent as the maximum rate of tax; the US Model Convention prescribes 15 percent as the maximum rate of tax and the UN Model Convention leaves the rate open for negotiation. The country of residence will give credit for the tax deducted in the source country to avoid double taxation and it is the gross interest which is taxed in the source country. Delhi Tribunal in case of *Rolls Royce Industrial Power (India) Ltd. v. Dy. DIT 73 taxmann.com 37* held that where the assessee, a non-resident UK company, earned interest on funds in UK bank accounts, it was not taxable in India in view of article 12(2) of DTAA between India and U.K. which gives taxing right to source state.

Paragraph 3 defines the term “interest” The definition is same in all three Models and it essentially means income from debt claims. The treatment/classification of interest as interest *simpliciter* or as relatable to the business i.e. as business income will be dictated by the domestic law and therefore the problems and complications would also follow. Unlike dividend definition, which recognizes the influence of domestic law, the definition of interest does not appear to adopt the domestic law definition. However, in certain cases the provisions of domestic law can be resorted to e.g., for determining whether penal interest paid is in the nature of penalty and therefore has to be ignored from the definition of interest, as per the DTAA.

Further, the withholding tax for Interest with few major countries is as mentioned in **Annexure A**.

In order to define the terms ‘debt’, etc. used in the DTAA, the local law that has evolved on the subject, is useful. A ‘debt’, simply put, is a sum of money

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which is payable or will become payable. Debt denotes an obligation to pay for the debtor and a right to receive for the creditor. This debtor-creditor relationship test is important to classify the payment as towards interest. Though the definition of interest seems simple and lucid, the interpretation has created a lot of litigation by the tax authorities. It has been given a broader meaning to the term 'debt-claim' by including interest on un-paid purchase price as interest [see *Bombay Steam Navigation Co (1953) Pvt. Ltd. v. CIT (1963)(56 ITR 52)*]. However, the Courts have given the logical meaning to the term to say that interest contemplates compensation for providing capital and relates to a debt and debtor-creditor relationship. Interest on trading account or for unpaid purchase price cannot be considered as interest on loan. [See also contra *CIT v. Vijay ship Breaking Corp. (2003)(261 ITR 113)(Guj)*]. In *CIT v. Visakhapatnam Port Trust (1983) (144 ITR 146)(AP)* it was held that where there was no intention to pay interest on the unpaid purchase price at the start the amount if any received cannot be treated as interest. In *Cargill Financial Services Asia Pte. Ltd. v. Asstt. DIT [2016] 76 taxmann.com 266 (Delhi-Trib.)* it was held that Indian AE endorsed promissory notes in favour of the assessee on 'without recourse' basis signified that all risks and rewards of promissory notes stood transferred to the assessee and in no case the assessee could make Indian entity liable to make payment in case of delay or default on maturity. Moreover, the assessee make payment of promissory notes to Indian AE as per the net present value. Thus, difference between the face value and net present value was to be regarded as business income and not interest income.

The AAR in *AAR No. P 17 of 1998 in re. (1999)(236 ITR 637)(AAR)* held that statutory interest refund due to the non-resident company also arises out of a debt claim and is taxable under this Article.

The effective source of interest has to be the principal debt. The interest from the debt has to accrue or should be received by the person who is the principal holder of the debt. If the debt is assigned or sold, the income received will not retain the character of interest.

The words at the end 'whether or not secured by mortgage....' are introduced out of abundant caution to ensure that irrespective of the treatment under domestic law, the interest arising on the debt is not linked to the property which is offered as security and assessed as income from immovable property. The debt retains its character and is distinct and separate from the

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property. Similarly the words 'whether or not carrying a right to participate in the profit' are also used to keep the identity of the debt and the interest arising therefrom distinct. However, if the loan is used as a means of financing capital and disguised as a loan the income could be considered as dividend and not interest. Therefore, the intention of the contracting parties and the treatment under domestic law or DTAA advantage which they may be trying to exploit should all be taken into consideration.

The definition of 'interest' in the Model commentary includes any income from debt-claims and income arising from investments. However, penal interest and penalties are excluded.

The recent OECD Model commentary also suggests that interest connected with funds from a special activity will be linked with that activity. Therefore, interest on shipping finance will be assessed under the shipping article.

Paragraph 4 provides for taxing the interest as business profits if it is related or attributable to the PE. Debt claims which form part of the assets of the PE or if it is effectively connected with the PE, it is taken as business income. Here, another concept that must be clear is that; for income to be taxed as income of the PE it must be clearly attributed to the PE and the doctrine of force of attraction cannot be imposed. The doctrine of force of attraction creates a fiction that all income is attributable to the PE. This fiction cannot be deemed, the connection between the debt and the income arising therefrom must be real. However, if the effective connection can be traced to the PE it would be income of the PE. Similarly, if the loan is taken for the purpose of the PE, it will be considered in arriving at the income of the PE.

Paragraph 5 para provides that if the interest is borne by a PE the interest will be deemed to arise in the State where the PE is located. This Paragraph deems the place of the payer to be the source of interest. The second part gives the exception where the residence will not be a determinative factor if the loan is taken specifically for and borne by the PE. However, the loan taken must have some connection with the requirement of the PE. The absence of such a relationship will render this clause inoperable.

Paragraph 6 incorporates the arm's length principle which provides that if the interest is artificially suppressed or augmented owing to a special relationship between the payer and the payee, the tax authorities may look into the substance of the transaction over the form and bring the correct amount of interest to tax. The conditions in paragraph 6 and the implementation thereof have to be read in connection with Article 9.

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AE and here again, the adjustment in profits cannot exceed the arm's length profit. Whether the loan is distinguished as capital or whether the rate of interest should be adjusted, would all have to be evaluated on the facts of each case.

In today's scenario money is sought from a source where the cost of funds is cheap and the terms are favourable. Raising funds internationally, debt and equity, is now a common trend even in India. International financing agreements are the most common feature of international trade. This article assumes great importance as the lender would obviously consider the tax implications for him, though most of the negotiation would try to pass on the burden of tax to the borrower, tax payable will ultimately add to the cost of funds.

In order to arrive at the taxable income, as discussed earlier, it will first have to be examined whether the income is taxable under the Act. If it is so, the quantum taxable after considering exemption if any available under the Act will have to be seen and ultimately, recourse can be had to the provisions of the DTAA if they are more favourable. The way the Act is worded, interest income would almost certainly be taxable in India unless it is exempted from tax. To encourage foreign investment there are a lot of exemptions available under the Act like section 10(15) which exempts interest payable by certain institutions engaged in important activities like housing and finance. There are also other concessional provisions in the Act like sections 115A, 115AC, 115AD, etc. which provide for a lower and flat rate of tax.

Interest - Amount paid by a thinly capitalised corporation

In certain countries owing to thin capital regulations, the loan provided by a shareholder may be treated as a part of the capital of the corporation and accordingly, the corresponding interest expenses on such excess debts re-characterised as equity, is not accorded similar treatment as interest. However, in India, in line with the BEPS Action Plan 4, section 94B was introduced within the Act.

Section 94B provides that where an Indian company or permanent establishment of a foreign company being a borrower incurs any expenditure by way of interest or similar nature exceeding rupees 1 crore to its Non-resident Associated Enterprises in respect of any debt issued as mentioned in the following cases then excess interest shall be disallowed:

- 1) Debt issued by Associated Enterprises or,

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2) Debt issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender,

Interest shall be calculated in the following manner:

Excess interest shall be disallowed whereas excess interest shall mean lower of the followings:

- i) Total interest paid or payable in excess of thirty percent of EBITDA (earnings before interest, taxes, depreciation and amortization) of the borrower in the previous year or,
- ii) Interest paid or payable to associated enterprises for that previous year

It may be noted that the provision uses the term total interest paid or payable and there is doubt whether the total interest includes only interest paid to non-resident associated enterprises or interest includes interest paid or payable by the entity to banks, financial institution, third party or any other resident related entities etc.

It may be pertinent to note that the objective of the provision to restrict the amount of interest paid to Non-resident associated enterprises and therefore, a view can be taken that the total interest means interest paid or payable to Non-Resident Associated Enterprises. Total interest will not include interest paid or payable to banks, financial institution, third party or any other resident related entities etc.

The Mumbai Bench of the Tribunal in the case of *Besix Kier Dabhol SA vs DDIT (ITA No. 4249 / Mum / 07)* dealt with the issue as to whether interest expenditure incurred by the PE to shareholders of the General Enterprise (GE) can be disallowed in the absence of thin capitalization rules in India.

In this case, the taxpayer was a Belgium based company (GE). It was setup with the sole business of executing a project of construction of fuel jetty and breakwater in India through its PE. It issued capital of approximately INR 38 lakhs held in the ratio of 60:40 by the two shareholders. PE of the taxpayer had also borrowed funds of approximately INR 9,410 lakhs from shareholders of GE in the same ratio of equity participation. This capital structure resulted into the debt equity ratio of the taxpayer to be 248:1. The interest paid by the PE to the shareholders of the GE on the above debts was claimed as deduction by the taxpayer. The tax authorities sought to

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disallow the interest expense on three grounds; firstly, the taxpayer had brought equity in the garb of debt and thus, the taxpayer was so thinly capitalized that its debt capital was required to be re-characterised as equity capital; secondly, payment of interest by the Indian PE to the Head Office constituted payment to self and accordingly, it is not allowable in terms of the India-Belgium DTAA; and the third reason given by the tax authorities is that the taxpayer violated RBI guidelines in respect of approval for setting up project office, which stated that the PE had to meet all its expenses from inward remittances received from Head Office and PE would not borrow from any person in India without permission from RBI and PE had not taken such approval.

As regards contentions of the revenue authority for disallowance of interest on the ground of thin capitalisation, the Tribunal held that India does not have the thin capitalisation rules till date although these are proposed in the Direct Taxes Code Bill, 2010 (DTC), the same could not be applied in the current scenario. To support this observation, the Tribunal placed reliance on the Supreme Court decision of *Azadi Bachao Andolan (supra)* and held that merely because a legislation is desirable and where the attempt are made to legislate the same subsequently, it would not make the existing provisions illegal. Further, when no limitation of benefits or anti abuse provisions are set out in the tax treaty, it is not open to the tax authorities to apply such provision. Thus, the Tribunal upheld the claim of deduction of interest. (The observations made by the Tribunal with respect to DTC in this case will still hold good, since DTC has still not been enacted.)

Under the provisions of the DTAA, in determining the profits of the PE, all expenses incurred for the business of the PE were to be allowed as deduction subject to the limitations placed by the laws of the State in which the PE is situated and certain specific limitations set out in the Articles of tax treaties itself. One of the limitations under Article 7(3)(b) of the DTAA is that the interest paid to avoid erosion of tax base in the source country on account of notional intra organisation deductions to the GE is not to be allowed as deduction unless it is towards reimbursement of actual expenses. However, the Tribunal, in the above case observed that this limitation would not affect the taxpayer since this was the only business carried on by the taxpayer and the interest was paid to the shareholders which were outside parties. The Tribunal also gave a very important observation that shareholders and company are separate entities. And that the taxpayer had

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borrowed monies from the outsiders, even if such outsiders were the shareholders. Hence, payment of interest to shareholders cannot be considered as payment to self.

Interest vis-à-vis Dividend - Distinguishing interest between interest *simpliciter*, dividends, business income or some other form of remuneration disguised as interest becomes important in order to prevent treaty abuse, by passing on remuneration as interest. In order to do this, it is essential to look at the substance over form of the transaction.

Correct classification of interest or dividend is important, especially in case where interest is paid to a non-resident without deduction of tax at source, the payment is not allowed as a deduction to a resident in computing the taxable income. A common form of treaty abuse is disguising a loan as capital investment in countries where dividend is treated liberally as compared to interest. The question which arises at the time of withholding tax is whether it should be on receipt or accrual/credit basis. The law in India inclines on whichever is earlier. The double taxation is avoided by giving credit for the tax paid/ deducted in the resident country. The taxable interest is not confined to interest actually received. What is essential is that the receiver must have unconditional access to the money [refer *J.Dalmia v. CIT (1964) (53 ITR 83)(SC)*]. However a mere book entry in the debtor's books does not constitute such an unconditional right [refer *CIT v. Toshoku Ltd (1980) (125 ITR 525 (SC))*].

It is essential here to note that the words used in Article 11 reproduced above are 'arising in a Contracting State'. The word 'arising' is broader than the word 'received' and is more comparable to accrued and includes a right to receive. Arising would mean which comes into being or originates in the source State. This gives right to the source State to tax it. [see *CIT v. Govind Prasad P. Nath (1987)*, *Thomson v. Moyse (1960)(39 ITR 35)(SC)*]. Deeming gives the interest income a statutory fiction. What determines the source of the interest income is the residence of the payer. The place where the contract is signed or the situs of the activity from where the interest flows is not essential. If the payer is a resident of India, the interest will be taxable under section 9(1)(v) of the Act. Whether interest accrues or arises or can be deemed to accrue or arise would depend upon the facts of each case. The compromise on the right of the sources State and resident State to tax interest is reached at an agreed rate of withholding tax by the source State. As in the case of dividend, here also the rate of tax has to be kept low so that

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the effective rate of tax in the country of residence is not excessive. In *CIT v. Saurashtra Cement & Chemical Industries Ltd. (1975)(101 ITR 502)(Guj)* the tax authorities were of the view that the taxpayer was liable to tax as agent of the non-resident company on the interest paid to it. The High Court observed that the non-resident company had not performed any part of the business in India and therefore the debt owed was not an asset of the foreign company in India and thus the interest in respect thereof was not taxable in India.

Therefore, a source country is given a right to tax the income, however, a compromise is reached on the rate of tax as the country of residence will always want to have first claim to tax its residents on their global income.

Under the Act, Finance Act, 2015 has levied additional tax on the non-resident engaged in the business of banking, for interest payable by the PE in India to the head office in addition to any income that would be attributable to PE.

5.15. Royalties and Fees for Technical Services (FTS)

The Article 12 of the UN Model is reproduced below:

“ARTICLE 12 – Royalties

- 1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.*
- 2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed.....per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting State shall by mutual agreement settle the mode of application of this limitation.*
- 3. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.*

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4. *The provisions of paragraph 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases, the provisions of Article 7 or Article 14, as the case may be, shall apply.*

5. *Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.*

6. *Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.”*

The three model commentaries which form the basis of treaties around the world follow the similar principles in respect of royalty, except that the OECD and US model commentaries are much same in substance that they both exclude the source state’s right to tax. On the other hand, the UN MC allows the source state to impose the tax, while restricting the rate of tax. A provision corresponding to Article 12(2) of the UN model is absent in OECD model, since it does not allow the sharing of taxing rights between contracting states.

The definition of ‘Royalty’ under 3 models is as under:

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OECD Model Convention	UN Model Convention	US Model Convention
The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience	The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience	The term 'royalties' as used in this Article means (a) any consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific or other work (including computer software, cinematograph films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience.

The withholding tax rates for royalty / FTS with few major countries are as mentioned in **Annexure A**.

The provisions for royalty and FTS under the Indian tax laws have been discussed in the earlier Chapter III dealing with "Income of foreign taxpayers". We shall now see how they are treated under DTAA.

Till Ay 2013-14 the Act provided a rate of 10 per cent for taxing royalties, which was increased to 25% vide Finance Act, 2013 (w.e.f.1 April 2014). Vide Finance Act 2015, the rate is once again restored to 10% (w.e.f. 1 April 2016).

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The rate specified in this Article is also a matter of bargain between the countries. A consensus needs to be reached to arrive at a uniform rate and a method of identification and allocation of taxing rights.

In order to understand what constitutes “royalty / FTS” and the nature of payments, it would be necessary to refer some of the major and relevant decisions on this.

In *CIT vs Ahmedabad Manufacturing & Calico Printing Co. [1983] (139 ITR 806) (Guj)*, the Court, while explaining the meaning of the term royalty, observed as follows:

“It is thus clear that in the case of secret processes, patents, special inventions, when right of exploitation is given by the owner of the inventions, patents, etc., to a third party, instead of outright sale, then, for the right to exploit these inventions, secret processes, some amount may be paid and

the amount paid may be co-related to the extent of exploitation. It is in this sense, as pointed out by Encyclopaedia Britannica that licence agreements for the exploitation of patents, inventions, etc., are being entered into in modern commercial world and as part of such agreements, even knowledge derived from his own experience and technical know-how for the most economical and efficient user of the patents, inventions, etc , are parted with by the licensor to the licensee.

....Though the amounts payable, calculated at the rate of one per cent. on net sales of the products manufactured by the assessee company under the terms of the agreement, is designated as " research contribution ", in fact and in substance, it is nothing else but " royalty " as known to law. We have extensively quoted above from the different recognised books of law and Encyclopaedia Britannica, to point out that in the modern commercial world, payments of this kind are known as royalties.”

This decision was relied upon by Delhi High Court in the case of *CIT vs. M/s Voest Alpine AG (2015) (274 CTR 0084)*, wherein it was held that the consideration paid for right to use the technical know-how etc. under the agreement would be taxable in India as 'royalty'.

In the case of *ITO v. Sriram Bearings Ltd. [1997] (224 ITR 724) (SC)* the Supreme Court held that the consideration for sale of trade secrets was in respect of the sale which is effected in Japan as mentioned in the agreement. Therefore, any part of the said amount cannot be said to be earned in India.

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Generally, while dealing with royalty, the treatment would depend on whether the transaction is a sale of the product / knowledge or a right to use the product / knowledge. If it is an outright sale, it would be a capital receipt or a business receipt depending on the facts of the case. If the receipt is capital in nature, it is not taxable and the payment may not be allowed as a revenue deduction. On the other hand, if payment is for the use of the product / knowledge the income, generally depending on the facts of the case, it would be taxable as royalties and the payment can be claimed as a deduction.

The taxpayer had entered into an agreement with a Swiss company for the manufacture of insulators, lightning arrestors etc. and the acquisition of know-how for the manufacture. A license was granted to the taxpayer to manufacture the product from the drawings and also to market the products in India and export it abroad in consultation with the Swiss company. The payment for the services rendered was for the transfer of information and payment by way of royalty. The taxpayer claimed the deduction of entire payment as revenue expenditure. The High Court observed that the taxpayer had acquired information and drawings for setting up a completely new plant for the manufacture of a completely new product. The parties, themselves, had categorised the payment in two parts in the agreement, i.e. the revenue part being characterised as royalty and the capital part as lump sum payment for the know-how and information. The Court concluded that 20 percent of the payment was allowable as revenue expenditure, as being attributable to technical advice regarding day-to-day operation, lay out etc. and the balance was disallowed as capital expenditure. [*CIT v. W. S. Insulators of India Ltd. (2000) (243 ITR 348) (Mad.)*]

In re, [1999] (238 ITR 296) (AAR), the issue before the AAR was, where the parent company allowed the access to / use Central Processing Unit in USA to subsidiary, whether payment for the same would be taxable as royalty as for use of or the right to use designs / model / plan / secret formula etc. The AAR held that it is the use of embedded secret software (an encryption product) developed by the applicant for processing raw data transmitted which falls within the ambit of article 12(3)(a) of the DTAA.

Whether a lump-sum payment for supply of designs and drawings (engineering for the kiln) can be considered as royalty was a question before the Andhra Pradesh High Court in the case of *CIT v. Klayman Porcelains Ltd. [1998] (229 ITR 735) (AP)*. The Court, based on close reading of the type of work / other terms of the memorandum held that the consideration was paid

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for construction / installation of kiln and hence, not for imparting any information concerning the working of / use of a patent, invention etc. to term as royalty.

In *CIT v. Neyveli Lignite Corporation Ltd. [2000] (243 ITR 459) (Mad)*, it was held that the payments made to non-resident for design and engineering was not taxable as royalty, as the purpose of the design / drawings is only to secure the consent of the assessee to the manner in which the machine is to be designed and manufactured. It was further observed in this decision as under:

“...10. The term ‘royalty’ normally connotes the payment made by a person who has exclusive right over a thing for allowing another to make use of that thing which may be either physical or intellectual property or thing. The exclusivity of the right in relation to the thing for which royalty is paid should be with the grantor of that right. Mere passing of information concerning the design of a machine which is tailor-made to meet the requirement of a buyer, does not by itself amount to transfer of any right of exclusive user, so as to render the payment made, therefore, being regarded as ‘royalty’ ”

In *Pfizer Corporation, In re [2004] (271 ITR 101) (AAR)* the applicant, a company belonging to the Pfizer group, was a tax resident of Panama and an owner of the technology information relating to certain products. A Company based out of Denmark acquired the trademarks and technology information related to the said products from applicant and paid consideration for the same. On the transfer of the dossier containing technology, it was contended that it was transfer of capital asset situated outside India. The AAR held that the technology information owned by the applicant was for a very long time used in India exclusively and therefore, available in India both in the form of a dossier as well as in intangible form. Therefore, the transfer of technical information in the form of a dossier was transfer of a capital asset. Further, the situs of the technical information, which was the subject-matter of the sale agreement, was not in India. Accordingly, it was held that it is a transfer of capital asset, not chargeable to tax in India.

In case of *CIT vs. Davy Ashmore India Ltd. (1991)(190 ITR 626) (Cal HC)*, High Court held that:

“...In the case of secret processes, patents, special inventions, etc., where the right of exploitation is given by an owner to a third party instead of an outright sale, then for the right to exploit them, the secret processes,

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designs, etc., and the amount paid which may be either in lump or a periodic one partakes of the character of royalty...

The Calcutta High Court in the decision of *N.V. Philips v. CIT [1988] (172 ITR 521)(Cal HC)* held:

“..from the dictionary meaning of the term 'royalty' it appears that the said term connotes payment periodic or at a time, for user by one person of certain exclusive rights belonging to another person. It appears that the person who grants the user of the exclusive right might have the sanction of law which guarantees the exclusiveness”

In a recent case of *Customer Lab Solutions (p.) (Ltd. v. ITO 95 taxmann.com 280, Hyderabad Tribunal* held that affiliation fee was onetime payment which did not provide for transfer of any technology. Since, the payment of affiliation fee did not involve any transfer of technical knowledge or use of technical knowledge, said sum could not be considered as royalty either under the Act as well as under the DTAA.

Thus, royalty connotes the payment for use or exploitation of an exclusive right in respect of any property including intellectual property right belonging to a person.

Whether the payment as royalty is to be considered as business income depends on the facts of the case. As we saw earlier, a mere purchase of goods from India does not vest a tax liability on the non-resident. However, services stand on different footing, as providing a service would definitely give rise to some income accruing / arising in India, giving rise to the question whether it is royalty / FTS or business income. This debate, of whether the payment constitutes royalty or business income, shall be seen in the course of our discussion.

The dictionary meaning of royalty is “a sum paid to a patentee for the use of patent or to an author etc. for each copy of a book sold or for each public performance of a work”. Therefore, an amount paid to obtain a right to use another property is royalty. The dictionary meaning is also “a royal right (in today's world esp. over minerals / any exclusive asset) granted by the sovereign to an individual or a corporation”.

This goes back to the origin of the term when royalty was paid to Kings who were the sole owners of gold and silver mines for the right to mine. Hence, from the 'royal' metal, the term “royalty” comes. A person may have the

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knowledge to invent a formula or a design model, but he may not have the wherewithal to manufacture or produce or to commercially exploit the patent / design. In such a case, he may allow a manufacturer to commercially exploit and develop it. This may either be by an outright sale or by giving a right to use while retaining the ownership. The payment for the later would constitute 'royalty'. The most common form of royalty is industrial royalty wherein the payment may be made based on production of output. In the case of books and films, the royalty may consist of a lump sum and an additional amount linked to the sales. In a contract for royalty, the terms of the payment, the extent of the right given to use the product, patent etc., as the case may be, all should be mentioned in the contract. In certain DTAA's, mining royalties are taxed under income from immovable property. However, this leads to a question that if, a mine quarry etc. are held to be a PE, as discussed earlier, can the income there from be taxed as royalty? The reply to this is in the generally understood principle that if an income can be clearly attributed to the PE it should be taxed under the Article dealing with business profits.

A brief analysis of the Article of the DTAA which deal with Royalty is as below:

Para 1 - This para gives the resident State the right to tax the royalty.

Para 2 - Recognizes the right of the State where the royalty is being used to also tax the same. However, here again, a compromise is reached in the rate of tax.

Whether the State in which royalty arises should be given a right to tax the royalty is a matter of debate between developed and developing countries. Developed countries feel that royalty is a result of their encouragement for the development of technology which they have given by various ways say supply of raw material at a concessional rate, tax breaks etc. Such things when used by developing countries, result in the industrial development, therefore, the right to tax should be reserved with resident State. However, the counter to that argument by developing countries is that, while capital and services may be provided by the developed countries, it is the developing countries which provide the management, labour and implementation. Therefore, both countries would have a right to tax the income royalty. The compromise between the source State and the resident State is again achieved by a reduced rate. Therefore, while para 1 gives the resident State a right to tax, para 2 recognises the right of the source State

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and a rate, negotiated by the two countries to give the source State a partial right.

A Contracting State accords a concession in favour of the other Contracting State by giving up its right to tax. This concession must benefit a real holder and not just some pass through entity as we shall see in the discussion on para 6. This rate has to be applied on the gross income, as determination of the net income for a source State is virtually impossible considering that the expenditure may have been incurred over a period of years and furthermore may have already been allowed by the resident State. To get over all these difficulties a lower rate is prescribed which should be applied to the gross income.

To determine whether the royalty arises in a contracting State, the location of the source has to be identified. If the source from which royalty is derived is located in a particular State, the royalty is said to or deemed to arise in that State. The taxability of royalty arises in the State where the licence is used and the place where it is paid has no relevance as held in *AEG Aktiengesellschaft v. IAC [1994] (48 ITD 359) (Bang)*.

When the Article talks about royalty paid, it does not consider only actual payment but would also consider constructive payment i.e. when the right to receive is made unconditionally available. Here, royalty is taxable if it arise or is deemed to arise in the Source State. The concept of arising is different from receipt, as seen earlier. The word arising signifies that the country of origin which might be distinct from the country where it is brought. The word 'arising' indicates a right to receive and represents a stage anterior to the point of receipt.

The Mumbai Tribunal in case of *Johnson & Johnson (2013)(60 SOT 109) (Mum)*, in terms of wording of Article 12(1) of DTAA between India and USA, observed that since the word used in the DTAA is 'paid' or 'received', amounts cannot be taxed on accrual basis. The similar is also held by Bombay High Court in the case of *DIT vs. Simesns Aktiengesellschaft (ITA No.124 of 2010)(Bom)* that the assessment of royalty / FTS should be made in an year in which amount are received and not otherwise.

Para 3 - Royalty as commonly understood is a fee or a consideration paid to another for the right to use his product, patent or knowledge etc. Technical service fee may be paid in connection with the patent, product etc. for which royalty / an isolated fee is paid for the use of service. The performance of a

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technical service does not involve the transfer of knowledge, however when 'know-how' is transferred, the operational or technical skill / knowledge is also transferred.

The definition of royalty has been kept wide to include not only patents and know-how which are normally used in manufacture/ industrial royalty, but also to cover other intangible rights like copyrights of literary artistic or scientific work. Rights to use films and television broadcasting are also covered. With the increasing advent and popularity of satellite T.V., the latter becomes very important.

The DTAA with USA / few other countries uses the term "included services" i.e. services which are necessary for the use of the asset. The definition of royalty is kept wide to include payments for all conceivable rights to limit escapement of tax from exploiting a right.

Another popular form of royalty payments is for right to use the brand name or franchising e.g. McDonalds will grant a franchisee to a restaurant to use his name and run a McDonalds outlet. The expertise, training of staff will all be provided by McDonalds and the quality standards will be prescribed. In return, the restaurateur will pay McDonalds a royalty which may be a lump sum or at X percentage of sales.

Technology is the scientific or organized knowledge of a way of doing something. Therefore, transfer of technology involves transfer of some knowledge and the payment for the use of such technology, which might constitute royalty or payment for technical fees. Know-how is also accumulated knowledge from years of research and such knowledge / information is not publicly available.

The technical fee is, generally, not considered in a separate Article. Normally, when the fee is not in connection with the right to use the product, patent etc., for which royalty is paid, it can be taxed as business income which, in the absence of a PE, may not be taxable.

Madhya Pradesh High Court in the case of *Hindustan Electrographites v. IAC (1984) (145 ITR 84)* held that charge / payment was not as consideration for the use of its patents / information / know-how but for technical or professional services to enable to adopt the modified design in the existing furnaces. It was held that the payments were payable for technical services and therefore, it was not royalty.

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Contribution by Indian companies towards the cost of the technical assistance provided by foreign company was not treated as payment for technical services as it was a contribution and not the payment - *Decta v. CIT (1999) (237 ITR 190) (AAR)*.

Payment for off-shelf software

In case of payment for off shelf software, an issue arises whether this would constitute 'royalty'. One may contend that this is an outright sale as against grant of right to use the software. There exist decisions on both the sides on this issue. In case, where it is held that import of shrink wrap software is the purchase of goods / copyright article, it is not considered as royalty; whereas when it is held that payment is for the use of or right to use any copyright, it will constitute royalty.

The Special Bench of the Delhi Tribunal in the case of *Motorola Inc. and Others v DCIT (2005)(96 TTJ 1)* had dealt with issue of whether the payment for software was taxable as 'Royalty' under the domestic tax law and under the tax treaties entered by assessee.

The taxpayer contended that the said payment is not royalty as there is no independent supply of software by the assessee (i.e. what is supplied is the hardware (GSM Mobile telephone equipment) and the wherewithal to make the hardware function, thereby the sale of software is part of the sale of hardware and not independent of it. It was also contended that the question to be decided is whether the assessee has given any copyright / transferred any right in a copyright or has given the use of copyright or has supplied a copy righted article.

The Special Bench held that:

184. In view of the foregoing discussion, we hold that the software supplied was a copyrighted article and not a copyright right, and the payment received by the assessee in respect of the software cannot be considered as royalty either under the Income-tax Act or the DTAA.

Thus, a clear distinction between supply / provision of a copyrighted article and a copyright right is brought.

The Karnataka High Court in the case of *Samsung Electronics (345 ITR 494)(Kar)* has held that payment for off the shelf software amounts to royalty not only under the Act, but also under India US tax treaty. The observations of the High Court are as under:

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“It is clear from the above said provisions of the Copyright Act that the right to copyright work would also constitute exclusive right of the copyright holder...”

“..Therefore, licence is granted for taking copy of the software and to store it in the hard disk and to take a back up copy and right to make a copy itself is a part of the copyright. Therefore, when licence to make use of the software by making copy of the same and to store it in the hard disk of the designated computer and to take back up copy of the software, it is clear that what is transferred is right to use the software, an exclusive right, which the owner of the copyright i.e., the respondent-supplier owns and what is transferred is only right to use copy of the software for the Internal business as per the terms and conditions of the agreement”

This decision has been relied upon by Mumbai Tribunal in the case of *Reliance Infocom Ltd. (ITA No.837/M/07, 5075/M/08), DDIT v. Reliance Communications Infrastructure Ltd (ITA No. 5468/M/08), DDIT v. Reliance Infostream Private Limited (ITA No.730/Mum/09), DDIT v. Reliance Telecom Ltd (ITA No 5093/M/08), ADIT v. Lucent Technologies GRL LLC (ITA No. 7001/M/10)*. The Tribunal in this case held that the consideration for supply of software which is not embedded in equipment is taxable as “royalty”. It was observed:

“..There is a distinction between a case where the software is supplied along with hardware as part of the equipment and there is no separate sale of the software and a case where the software is sold separately. Where the software is an integral part of the supply of equipment, the consideration for that is not assessable as “royalty”. However, in a case where the software is sold separately, the consideration for it is assessable as “royalty””

In *Lucent Technologies Hindustan Ltd vs ITO [2005] 92 ITD 366 (Bang)*, the Bangalore ITAT dealt with the taxability of a US company that supplied certain telecom equipment to its Indian subsidiary. As a part of this transaction, software was provided which was inextricably linked to the hardware and both were such that one cannot function without other. It was held that the taxpayer had purchased a copyrighted article and not acquired any copyright of the rights in the software. Thus, the payment could not be classified as royalty.

Similarly, Delhi HC in case of *DIT vs. Ericsson A.B., New Delhi (2011)(16 taxmann.com 371)* held that supply of software would not give rise to royalty.

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In this case, the Assessee earned the income as a result of supply of hardware and software licence under the supply agreement. The finding of fact was recorded by the Tribunal that the cellular operators did not acquire any of the copyrights. It was observed that GSM sold to customers consisted both of the hardware as well as the software, however, the supply contract cannot be separated into two viz., hardware and software. It was therefore held that the payment received by the assessee was towards the title and GSM system of which software was an inseparable parts incapable of independent use and it was a contract for supply of goods and therefore cannot be classified as payment towards royalty.

However, the Delhi High Court in the case of *DIT vs Infrasoft Ltd. (2014)(220 Taxman 273)(Del)* expressed a disagreement with the decision of Karnataka High Court in Samsung's case and observed that the license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use was only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purposes and not giving rise to royalty.

Thus, one has to see the factual aspect viz. whether software supplied is inextricably linked / part of the hardware or it can be sold separately as also the judicial position existing at that time to determine the taxability

Use of Satellite / Transponder Hire charges

Another type of arrangement is the use of satellite / transponder. In this case, the payment is made for using it for uplinking and downlinking. The issue is whether such payment can be said to be falling within the definition of royalty.

Delhi High Court in the case of *Asia Satellite Telecommunications Co vs DIT (2011) (332 ITR 340)(Del)* held that payment for allowing access to transponder will not be royalty. The assessee, who was engaged in the business of private satellite communications and broadcasting facilities, had entered communication / other companies to utilize the transponder capacity available on its satellite to relay their signals, who were based outside India. The footprint area of those satellites covered the territory of India. The High Court observed that the transponder is in the orbit. Merely because, it has its footprint on various continents, it would not mean that the process has taken place in India. It held that there is no use of 'process' by the TV channels.

The effect of this verdict was seemingly overturned in view of the retrospective amendments to the definition of Royalty, which covered the

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payment for the use of process that is transmitted *inter alia* by satellite, cable, optic fibre etc. However, one has to consider this in light of language of tax treaty as well, as there have been several judgments post the amendments by Finance Act 2012, which lay down the principle that amendments under the Act cannot affect the treatment under the tax treaty - *New Skies Satellite BV (ITA 473 and 474/2012)* and *Shin Satellite Public Co Pvt. Ltd. (ITA 500 and 244/ 2014)*, dated 8 Feb 2016.

Royalty for technical knowhow:

The CBDT, in the context of norms and principles to be applied in assessing foreign / Indian participants in technical collaboration observed that technical know-how is a term of wide connotation and includes several kinds of technical knowledge, assistance and services. (Circular: No. 21 [F. No. 7A/40/68-IT(A-II dated 9-7-1969)). There are several ingredients constituting technical know-how such as:

- (i) the design of the product to be manufactured,
- (ii) the design of the process of manufacture,
- (iii) the design and engineering of the plant,
- (iv) the erection of and the commissioning of the plant etc.

The consideration paid for the transfer of know-how is defined in the DTAA as meaning royalty. For this purpose, technical know-how means the knowledge concerning industrial, commercial or scientific experience. It is the undivulged technical information whether capable of being patented or not, that is necessary for the industrial production of a product or process - *Advance Ruling P. No. 30 of 1999 [1999] (238 ITR 296) (AAR - N. Delhi)*.

In case of *Voest Alpine A.G. (2015)(230 Taxman 405)*, Delhi High Court held that the payment under technical assistance agreement i.e. consideration paid for right to use technical know-how etc. would be taxable as 'royalty' and it would be taxable in India to the extent it is attributable to the activities actually performed in the country of source.

The OECD Commentary on article 12 refers to the following key elements to identify transactions for the provision of know-how:

- It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the

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disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer

- In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remains unrevealed to the public
- In the know-how contract the grantor is not required to play any part himself in the application of the formula and does not guarantee the results thereof.
- Contract of know-how differs from the contract for “provision of services, in which one of the parties undertakes to use customary skills of his calling to execute work himself for the other party”.

The following examples are not to be considered as for the provision of know-how, but rather, for the provision of services:

- Payments obtained as consideration for after-sale service;
- Payments for service rendered by a seller to the purchaser under a guarantee;
- Payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information;
- Payments for pure technical assistance;
- Payments for an option given by an engineer, an advocate or accountant;
- Payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.

Consideration for industrial, commercial, or scientific experience –

DTAAs include the consideration for information, concerning industrial, commercial or scientific experience as royalties. The term “industrial,

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commercial, or scientific experience” has the meaning assigned to it in paragraph 11 of the OECD Commentary on Article 12, which states that the term alludes to the concept of “know-how”.

The words "payments ... for information concerning industrial, commercial or scientific experience" are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. In a recent case, *Marck Biosciences Ltd. 80 taxmann.com 275*, the Ahmedabad Tribunal held that payment to a US company on account of professional fee for global bio-pharmaceutical strategic counselling and advisory services are payment made for rendition of services even though in process of availing these services, the assessee benefited from rich experience of the service provider. The payment was categorized as consideration for rendition of services, and not for right to use information concerning industrial, commercial or scientific experience, in possession of US company. Accordingly, it was held that such payment would not qualify as royalty as defined under article 12(3)(a) of India-US DTAA.

Composite contracts – A composite contract refers to a contract for more than one service or one thing. In case of a composite contract, the split has to be seen. In the case of *CIT v. Sundwiger EMFG and Co. (2003) (262 ITR 110) (AP)*, the payment to the staff of non-resident supplier in connection with technical services covering supervision of erection, start of machinery i.e. various capital equipments supplied, was held to be a part of the sales price as the services rendered by the experts and the payments made towards the same, were part and parcel of the sale consideration in connection with supply of machinery.

In case of *Biocon Biopharmaceuticals Private Ltd. (2013)(144 ITD 615)(Ban)*, Tribunal held that in case of mixed contract, the consideration attributable to know how and as pertaining to technical service should be bifurcated. It held:

“..57. We should keep in mind that there can be mixed contract for supply of know-how and technical services in consideration of lump sum payment. The lump sum consideration must be broken down into parts and that part of the consideration attributable to know-how has to be brought to tax as 'royalty' assuming that the consideration paid is for imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill. That part of the consideration attributable to providing

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'technical services' has to be brought to tax as fees for technical services rendered. Such apportionment has to be on the basis of the information specified in the contract itself or on some other reasonable basis. If, however, one element constitutes 'by the principal purpose of the contract' and the other element is "only of an ancillary and largely unimportant character", the whole amount paid should be treated as relating to the primary element.

One of the landmark judgments of all times which is used to state the law on this is the classic *CIT vs. Mitsui Engg. & Ship Building (2002)* (123 Taxman 182) wherein *Inter alia*, it was held that it is not possible to apportion the consideration for design on the one part and engineering, manufacturing, shop testing, packing up to FOB port of embarkation on the other. Therefore, the transfer of design, if any, vis-a-vis other would not come within the purview of the said Explanation (i.e. royalty).

To consider the composite contracts, the agreement as a whole has to be seen. In case of *Daimler Benz AG v. West Germany [1991]* (36 ITD 508) (Bom), where the agreement was for imparting technical know-how along with license to manufacture, it was held that royalty would cover lump sum payments. (See also *Atlas Copco MCT AB of Sweden v. ITO [1991]* 39 ITD 328 (Bom). In case of *TNT Express Worldwide (UK) Ltd 70 taxmann.com 129*, Bangalore Tribunal held where assessee is unable to provide bifurcation of payment relating to each kind of services, then as per OECD model Tax Convention, other part of services can also be given tax treatment as given to principal part of services.

The Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd v. Director of Income-tax [2007]* (158 Taxman 259) (SC) had an occasion to consider these aspects in greater details, where the taxability of a turnkey contract was into the question. The Supreme Court held that though the contract is a turnkey contract, it would not mean that even for taxation purpose, the entire contract must be considered to be an integrated one so as to make the appellant to pay tax in India. The taxable events as also the liability of the parties in a contract, may arise at several stages / several years with distinct obligations e.g. supply obligation is distinct and separate from service obligation. On facts, it was observed that price for each of the component of the contract is separate; similarly offshore supply and offshore services have separately been dealt with.

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It further observed that the very fact that in the contract, the supply segment and service segment have been specified in different parts of the contract is a pointer to show that the liability of the appellant thereunder would also be different. The contract was indisputably executed and entered in India, although parts thereof will have to be carried out outside India would not make the entire income derived by the contractor to be taxable in India.

This decision has been relied by AAR in its Ruling in case of the Sepco Iii Electric Power Construction Corporation (AAR No. 1008 of 2010, decided on January 31, 2012) to hold that offshore supplies are not taxable in India. It was held that in the light of decision of the Supreme Court in *Ishikawajima Harima Heavy Industries Ltd.* (supra), the argument that the transaction must be taken as one and indivisible and the liability to tax should be determined on that basis, cannot be accepted. It is also relied by Bombay HC in case of *DIT vs. Xelo Pty. Ltd.* (2011)(203)(Taxman 475)(Bom).

The AAR in the case of *Roxar Maximum Reservoir Performance WLL* (2012)(349 ITR 189) (AAR) held that payment received under composite contract for supply and installation / commissioning of equipments is a composite contact and cannot be segregated and hence, it is liable to tax in India. It observed that adopting a dissecting approach as done in two judge bench decision in case of *Ishikawajima-Harima Heavy Industries Ltd v. DIT* (supra), could not be followed considering that the decision in *Vodafone* has been rendered by a three judge Bench which provided that transaction is to be looked as a whole. It further held that all payments received by the applicant under the composite contract is income chargeable to tax in India under the provisions of the Act.

However, Delhi HC in case of *Linde AG, Linde Engineering Division And Anr., Petitioners vs. DDIT* (2014)(365 ITR 1)(Del), the High Court while ruling in favour of assessee observed that facts of given case are quite similar to the facts as in the case of *Ishikawajima-Harima Heavy Industries* (supra) – as far as obligations parties are concerned, the Contract is an indivisible one. However, for the purposes of tax, the Contract does specify the amounts with respect to the various activities carried on by them. The Court observed that the decision of the Supreme Court in *Ishikawajima-Harima Heavy Industries* (supra) is clearly applicable and where the equipment and material is manufactured and procured outside India, the income attributable to the supply thereof could only be brought to tax if it is found that the said income therefrom arises through or from a business connection in India. It further

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observed that the taxable income in execution of a contract may arise at several stages and the same would have to be considered on the anvil of territorial nexus.

Paras 4 and 5 - Para 4 and 5 are the exceptions to paras 1 and 2. Para 4 provides that if the royalty is effectively connected with the PE, the royalty will be deemed to arise in the State in which the PE is situated. Para 5 provides that royalty will arise in the State where the payer is a resident. However, if the payer has a PE in the State and the royalty is obtained in connection with the PE and is borne by the PE, then the royalty will be deemed to arise in the State in which the PE is situated. In that case the royalty will be assessed as business profits under Article 7 or Article 14 if it can be attributed a fixed base.

In *AAR P.No.13 of 1995 In re [1997] (228 ITR 487)*, a French company provided turnkey services to an Indian company under seven different agreements. The French company was deemed to have a PE in India and the royalties / technical fee to the extent it was attributable to the PE, was taxable in India.

Para 6 - The benefit of the lower rate of tax is given to the person who is the ultimate recipient of the royalty, provided he is the resident of the other contracting State. The intention is to give the benefit to the correct person and to avoid treaty shopping by putting a resident of a country where royalty is exempt or not taxable as the front or where a person tries to obtain DTAA benefits indirectly which would not be directly available to him. There has to be a close and real nexus between the resident and the resident State, which is to be ascertained from the facts of each case. A State accords a concession by giving up its right to tax. This concession must benefit a real holder and not just some pass through entity. This rate has to be applied on the gross income, as determination of the net income for a resident State is virtually impossible considering that the expenditure may have been incurred over a period of years and furthermore may have already been allowed by the resident State. To get over all these difficulties a lower rate is prescribed which should be applied to the gross income. To determine whether it arises in a contracting state the location of the source has to be identified. If the source from which royalty is derived is located in the state it is said to or deemed to arise in that State.

In order to control artificial suppression of or augmentation of profit, Para 6 also gives the tax authorities the right to apply the arm's length principle and

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to decide whether the royalty paid is excessive, owing to a close relationship between the payer and the recipient. This excess can be dealt with as per the local laws.

FTS

FTS was not separately defined in the UN Model earlier. However, 2017 update of the UN model has introduced Article 12A relating to Fees for Technical Services as under:

1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed ___ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term “fees for technical services” as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:

- (a) to an employee of the person making the payment;
- (b) for teaching in an educational institution or for teaching by an educational institution; or
- (c) by an individual for services for the personal use of an individual.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with:

- (a) such permanent establishment or fixed base, or
- (b) business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

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5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.

6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.

7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

The definition in Article 13(4) of the U.K. DTAA reads as under:

“4. For the purposes of paragraph 2 of this Article, and subject to paragraph 5, of this Article, the term “fees for technical services” means payments of any kind of any person in consideration for the rendering of any technical or consultancy services (including the provision of services of technical or other personnel which :

- (a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3(a) of this Article is received; or*
- (b) are ancillary and subsidiary to the enjoyment of the property for which a payment described in paragraph 3(b) of this Article is received; or*
- (c) make available technical knowledge, experience, skill, know- how or*

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processes, or consist of the development and transfer of a technical plan or technical design.

5. The definition of fees for technical services in paragraph 4 of this

Article shall not include amounts paid:

- (a) *for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property, other than property described in paragraph 3 (a) of this Article;*
- (b) *for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships, or aircraft in international traffic;*
- (c) *for teaching in or by educational institutions;*
- (d) *for services for the private use of the individual or individuals making the payment; or*
- (e) *to an employee of the person making the payments or to an individual or partnership for professional services as defined in Article 15 (Independent personal services) of this Convention”*

The term FTS has been generally defined in the Act as meaning “consideration for the services of a managerial, technical or consultancy nature, including the provision of services of technical or other personnel”

- Connotation of technical services:
 - Technical services mean services requiring expertise in a technology
- refer *Memorandum of Understanding (MOU) to the India-US DTAA;*
 - ‘Technical service’ referred to in section 9(1)(vii) contemplates rendering of a ‘service’ to the payer (of the fee). The popular meaning associated with ‘technical’ is involving or concerning applied and industrial science. Mere collection of a fee for use of a standard facility provided to all those, who are willing to pay for it, does not amount to fee having been received for technical services – *Madras High Court in Skycell Communications Ltd vs DCIT [2001] (251 ITR 53) (Mad)*
 - Technical service would also include professional service such as running a well equipped modern hotel – Supreme Court in

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CBDT vs Oberoi Hotels (India) Pvt Ltd [1998] (231 ITR 148) (SC);

- Strategy consultancy services such as marketing and sales strategy, business strategy and portfolio strategy, etc. are not 'technical' in nature – Mumbai Tribunal in the case of *DCIT vs Boston Consulting Group Pte Ltd [2005] 93 TTJ 293 (Mum)*
- Where simply an equipment or a standard facility albeit developed or manufactured with the use of technology is used, such a user cannot be characterized as using 'technical services' - *Ups Sci (Asia) Ltd Mumbai vs ADIT, (ITA No.2426/Mum/2010 dated on 22 February 2012)*

— Connotation of managerial services:

- Managerial services mean services requiring expertise in industrial or business management techniques. Thus, managerial services mean services by persons having knowledge and experience in industrial or business management techniques
- 'managing' in the context of managerial service encompasses not only the simple execution of a work, but also certain other aspects, such as planning for the way in which the execution is to be done coupled with the overall responsibility in a larger sense - *Ups Sci (Asia) Ltd Mumbai vs ADIT (2012)(50 SOT 268)(Mum)*

— Connotation of consultancy services: Consultancy services mean advisory services. Consultancy service could also be a technical service. Consultancy services might be advisory services relating to managerial or technical matters. The categories of technical and consultancy services are to some extent overlapping because a 'consultancy' service could also be a technical service – refer *Memorandum of Understanding (MOU) to the India-US DTAA*.

— The word "consultancy" means giving some sort of consultation de hors the performance or the execution of any work. It is only when some consideration is given for rendering some advice or opinion etc., that the same falls within the scope of "consultancy services" - *Ups Sci (Asia) Ltd Mumbai vs ADIT (2012)(50 SOT 268)(Mum)*

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India USA treaty does not seem to include managerial services within its ambit.

Moreover, there are certain DTAA's entered into by India (e.g. with US, UK, Singapore), where fees are considered for technical services only if the technical services make available to the person acquiring the service technical knowledge, experience, skill, know-how or processes or consists of the development and transfer of a technical plan or technical design to such person. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology independently. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc., are made available to the person purchasing the service. Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plants or technical designs, or making technology available may include engineering services (including the sub-categories of bio-engineering and aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering), architectural services and Computer software development.

The 'Memorandum of Understanding concerning Fees for Included Services in Article 12' (MOU) describes the category of services within the definition of Fees for Included Services (FIS) in detail. It also provides various examples to illustrate the concept of FIS. According to the MOU, the definition of FIS in the India-US DTAA includes only certain technical and consultancy services.

It would be quite apposite to refer to some of the illustrations referred to in the MOU appended to the India-US DTAA as these would help in understanding the concept in greater detail and their practical application:

Example:

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company

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how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for “included services”?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill and processes.

Example

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plant or design. The U.S. company is merely performing a contract manufacturing service.

Example

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to assess the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a

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technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer programme) which it has developed.

Example

Facts:

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product worldwide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of the 4(b).

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Royalty / FTS or business profits - The eternal debate

Payment for royalty for technology usage is the most common form of royalty.

The eternal debate is the classification of the amount either as a royalty or business profits. Normally, the person supplying the equipment or the know-how will also supply the services of his employees to train in respect of the use of the equipment and allow the trade mark to be used; the payment for the equipment along with the trade mark and technical services will amount to payment for royalty / FTS. On the other hand, if the person rents the equipment in the normal course of his business, it is business income. A similar view was taken in *CEPT v. Shri Lakshmi Silk Mills Ltd. [1951] (20 ITR 451) (SC)*. This decision was also relied upon by Karnataka HC in case of *CIT vs. Mysore Wine Products Ltd. (Since Amalgamated With Mcdowell Spirits Ltd. And Later Renamed As Mcdowell And Co. Ltd. (2015)(370 ITR 102) (Kar)* wherein it was observed that what is leased is the commercial assets of the assessee. When the commercial asset was given to the lessee, the intention was not to lease but to exploit the commercial asset through his expertise and derive income. Therefore, in view of section 56(2)(iii) coupled with judicial precedents, the income should fall under the head "Profits and gains of business" and not from "income from other sources". While deciding whether the income is royalty or business income the courts will give importance to the special pro which overrides the general provision as held in the case of *CIT v. Copes Vulcan Inc. [1987] 167 ITR 884 (Mad)* where the court held that if the nature of income is such that it is FTS it must be taxed under the special provision and a deeming concept would apply irrespective of whether there was a business connection to not and the FTS would be covered by the special provision.

In *AAR P. No. 30 of 1999, In re [1999] (238 ITR 296)(AAR)* as discussed above, the payment for using the software / intellectual property was held as royalty and not business income.

Transfer of technology can be through various forms, e.g. Transfer of computer software or transfer of human skills. However, if the right to use an equipment is given it is not royalty but business income. Royalty also involves transfer of intellectual property rights. These are rights over a creation which requires skill and knowledge of an individual or an organization. These can include copyrights which relate to literary, scientific

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or artistic work. These rights would be protected by a license or a patent. It is the license or patent which would be allowed to be exploited.

Another important development in royalty is transfer of technical service. In certain cases the patent or the design is transferred and the person who pays for its use is capable of using it independently without the help of the owner/producer/inventor. However, in some or most cases this may not be possible. In that case, the owner/producer/inventor would also provide his people to demonstrate the usage, or help in the installation or modification of the know-how. This would be characterised as a technical service. The place where it is used would have the right to tax it. The transfer of technical services does involve transfer of knowledge along with the transferor taking responsibility for its implementation and results. In most DTAA's, technical fees used to be grouped with royalties. However, considering the increasing movement of skilled labour, the technical fees are now being mentioned in a separate Article in a few DTAA's.

As regards transfer of software, the issue could be whether the transfer constitutes transfer of right to use and therefore royalty or it would be transfer of goods and therefore business profits or capital gains. Software is a set of instructions for the computer to perform the directed tasks. Software is normally protected and while the user gets a right to use, the ownership is retained with the writer of the programme. This may tantamount to royalty or business income depending on the facts of each case. When it is only a right to use without the right to change /modify or make copies as such but to be used in the business of the acquirer it will be business income. However, if something more is transferred i.e. right to market it or copy it; it is transfer of/for royalty. If the entire software is sold with relinquishment of all rights it is a capital gain.

In case of *DCM Ltd. v. ITO (1989)(29 ITD 123)(Del)* on the facts of the case the amount paid in respect of collaboration agreement was held to be business profits as it did not fit into the definition of royalty in the India –UK DTAA and held not taxable in the absence of a PE.

In *Lind A.G. v. ITO (1997)(62 ITD 330)(Mum)*, it was observed that procurement charges (in respect of service for making purchases by the assessee to be used in fabricating the plant) was pure commercial service and not technical services.

In case of *IMG media Ltd.* 67 taxmann.com 343 Mumbai Tribunal held that where assessee, a UK based company, entered into agreement with BCCI

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for capturing and delivering of live audio and visual coverage of cricket matches, since assessee did not retain ownership of programme content, payment received for rendering aforesaid service was to be taxed as business profits and not as royalty.

In *Dr. Reddy's Laboratories Ltd. v. Addl. CIT 78 taxmann.com 63*, Hyderabad Tribunal held that assessee, only provided final results to its Indian client by using highly sophisticated bio-analytical know-how, without providing any access whatsoever to clients to such know-how, fee received by it was business income and not fee for technical/included services or royalty.

These may also be cases of joint-venture between a resident and a non-resident. In such cases, the payment / income may have to be broken down into royalty / business income unless the income squarely falls under one of the two heads. Where the business is carried on through a PE and the payment is effectively connected and borne by with the PE it would be taxable as business income.

E-commerce has revolutionised the way business is done today. This has implications on the interpretation of PE i.e. whether a server constitutes a PE or not and also has implications on this Article i.e., whether subscription charges paid for access to database constitutes payment for royalty or not. The views taken by the Appellate authorities on the contentious issues surrounding E-commerce are discussed in detail in the section dealing with contentious issues on E-commerce.

Therefore, the ambit of taxability of royalty and technical fee would depend on the extant law, wordings of the DTAA and the judicial pronouncement evolved at domestic and international level.

5.16. Capital Gains

The UN Model of the Article reads as under:

“1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other

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Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.”

Article 13 of the United Nations Model Convention consists of the first four paragraphs of Article 13 of the OECD Model Convention. Paragraph 5 is a distinct provision in the United Nations Model Convention. Paragraph 6 is the same as paragraph 5 of the OECD Model Convention.

Para 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise. For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of Article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State. However, it is not applicable in the following cases:

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- Gains derived from alienation of immovable property situated in the country of residence or in any other third state;
- Alienation of shares in a real estate company; or
- Alienation of shares which carry the right to occupy an immovable property.

Para 2 applies when movable property of a permanent establishment (or a fixed base) is alienated as well as when the permanent establishment as such is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment.

Gains from alienation of movable property other than those specified in Para 2 of Article 13 are taxable in the country of residence as per Para 6 of Article 13.

Para 3 provides an exception from the rule in Para 2 for ships and aircrafts operating in international traffic and movable property pertaining to the operation of such ships and aircrafts.

Para 4 allows the taxation of the entire gain attributable to the shares or comparable interests to which it applies even where part of the value of these shares or comparable interests is derived from property other than immovable property located in the source State. The determination of whether shares of a company or comparable interests derive, at any time during the 365 days preceding the alienation, more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company, entity or arrangement without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).

Article 13(4) is intended to prevent tax avoidance in situations where the capital gains tax on sale of immovable property is sought to be evaded in the source jurisdiction through the formation of a company, where ownership of shares, carries the right to occupy immovable property.

Article 9 of the MLI on 'Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property' is modelled

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after Article 13(4) as recommended by BEPS Action Plan 6 (Preventing of tax Treaty Abuse).

Several taxpayers started adopting aggressive methods to by-pass the applicability of Article 13(4) leading to base erosion. One such method was to contribute assets to an entity shortly before the alienation of shares/comparable interests so as to dilute the proportion of the value of the entity that is derived from immovable property. Article 9 seeks to curb this kind of mischief by providing that Article 13(4) should only apply to situations where shares/comparable interests derive their value substantially from immovable property at any time during a defined period as opposed to at the time of alienation. In addition, Article 9 seeks to expand the scope and applicability of Article 13(4) by bringing within its ambit other participation rights and comparable interests such as interests in a partnership or trust.

Para 5 provides for taxation of a gain on the alienation of shares and comparable interests as contemplated in Para 4 but excludes gains from the alienation of shares to which para 4 of Article 13 of the Convention applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 12-month period preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12-month period.

Retrospective amendments were made by Finance Act, 2012 in section 2(14), 2(47) and section 9(1)(i) of the Income-tax Act, with an intent to overrule the Supreme Court ruling in case of *Vodafone International Holdings BV vs. UOI (2012) 17 taxmann.com 202 (SC)*. These amendments may not override the provisions of the Tax Treaty on account of the following reasons:

- Unilateral amendments made in the Domestic law cannot amend the provisions of the Tax Treaties;
- Article 13(5) does not accommodate a 'look through' approach which is contemplated by amendment in Section 9 of the Income-tax Act.

However, it may be noted that presently the availability of treaty benefits will be subject to GAAR

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Para 6 is a residuary para which provides taxing right to the country of residence of the transferor. Different countries may enter into bi-lateral negotiations to tax certain sources of income in the residence or source jurisdiction.

5.17. Independent personnel services (IPS)S

The UN Model of the Article reads as under:

“ARTICLE 14 – Independent Personal Services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State.

- (a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or*
- (b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other state.*

2. The term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.”

Clause (c) of paragraph 1 of Article 14, which read as under, has been dropped in revised UN Model, 2001.

“(c) if the remuneration for his activities in the other Contracting State is paid by a resident of that Contracting State or is borne by a permanent establishment or a fixed base situated in that Contracting State and exceeds in the fiscal year ... (the amount is to be established through bilateral negotiations).”

This Article is one of the Articles dealing with DTAA benefits for individuals and in particular deals with professional services rendered.

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Para 1 - This para contains the rules and the exception for taxation of the income derived by a resident of a Contracting State from the rendering of professional services. The right to tax is reserved with the resident State as this is recognized as the primary right. However, if the service rendered is attributable to a fixed base in the State where the service is rendered that State would also get the right to tax it; or if the person rendering the service stays in that State for more than 183 days the Source State would again get the right to tax the income. This is because the fixed base or a long stay denotes some nexus and connection with the State thereby giving it a right to tax it.

The resident State's primary right to tax the income is similar to its claim on royalty that the capital investment in the development of the person has come through its provision of subsidized education and other benefits. The source State's right comes from providing a place to exploit the knowledge to earn income. This compromise is reached by giving the source State, a right to tax based on continuous presence or a fixed base.

The resident State retains the right to tax primarily, as it is the resident State and secondly to encourage people to provide services in the developing country and also as much as the payment of tax, it is the administrative hassle of complying with the tax jurisdiction of a foreign State and subsequently claiming credit in the resident country it is easier to allow the resident State to tax it.

The concept of fixed base though akin to a PE is not as wide as PE. In case of article of business income, key requirement is business should be carried through such PE, whereas in case of fixed base, one needs to see whether it available to service provider at its disposal. Both have to be understood as giving a fixed point of identification with the non- resident and must exist for a reasonable / long enough time to prove a nexus with the source State. Our discussion earlier on what constitutes a PE is equally relevant here. Lack of proper definition has left it susceptible to various definitions. However, unlike in case of PE, the agency relationship cannot create too many problems as it is unlikely that a professional would have an exclusive agent. Though complications arise in case of group activities to identify whether a PE available to one of them can be said to be available to all of them? However, it would be difficult to hold that all do not contribute to the joint income which has connection with the fixed base. In fact the OECD, on the recommendation of Committee on Fiscal Affairs, deleted this Article in the

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Model Tax Convention on 29th April 2000 as it was felt that the concept of PE and fixed base being similar this Article could be withdrawn and the income be taxed under Article 7. However, the UN Model recognizes the difference between business and profession and therefore contains the separate Article.

The 'attribution rule' seen earlier and also the discussion on 'in connection with PE' would be relied upon in this case. The income should have connection with the fixed base. Income means receipts minus expenses i.e. net income is considered. Again here, only the income which can be attributed to the fixed base on account of the professional services rendered will be taxable in India. [*Barendra Prasad Roy v. ITO (1981) 129 ITR 295 (SC)*]. Only so much of the income as is derived from his activities performed in the other State may be taxed in that State - *Cedrick Jordan Da Silva vs ITO (2014)(62 SOT 239)(Pan)*

Para 2 - Explains the term professional services. The term professional service includes doctors, lawyers etc. and are to be understood and interpreted as dealt with in the Act. As we saw earlier, there is a difference between a business and a profession. All professions may constitute a business but all businesses are not professions, though a professional may carry on his profession in a commercial manner. The term profession denotes rendering of some intellectual service which requires some specialized skill or knowledge and is different from occupation which is generally the activity of production or sale. The distinction between a service rendered and an independent professional service rendered is recognized by separate Articles dealing with both. Article 15 - 'Dependent Personnel Services' deals with services rendered by 'an employee' on secondment or loan or transfer to another State. However, entertainers and sportsmen are dealt with in a separate Article i.e. Article 17 "Income Earned by Artistes and Sportsmen". In fact, in some DTAA's, the scope of this Article is widened by using the words "other independent activity of similar character", which signify other than professional activities which can be carried on independently to generate income.

The Mumbai Tribunal in *Clifford Chance UK v. Dy. CIT (2002) (82 ITD 106) (Mum)* observed that the activities, which constitute carrying on business, need not necessarily consist of activities by way of trade, commerce or manufacture or activities in the exercise of a profession or vocation. They may even consist of rendering services to others, which services may be of a

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variegated character. Merely because a person happens to be professionally qualified, it cannot be said that such person's activity cannot be treated as an activity of carrying on business. The professional activity can also be characterized as an activity of carrying on business if it is carried on like a commercial activity. Therefore, it is important to see that how the activity is carried on.

Few treaties e.g. with UK, covers entities other than individuals also as rendering professional services. - *Maharashtra State Electricity Board v. Deputy Commissioner of Income tax [2004] (270 ITR 36) (Mum)(2004)*

General attributes of professional are:

- An advanced level of knowledge acquired through formal training in the chosen practice area
- Specialized skill sets and experience acquired through dedicated practice in the chosen and
- Accreditation to a certificate of practice issued by a relevant professional body

Some of the issues involved:

Is the place from where the service is rendered important or the place where the service is utilised? In *Stephen, Robertson & Kristen consultancy Engineers & Scientists v CIT (1998) (230 ITR 206) (AAR)* the AAR held that the place where the services are rendered is not essential but the place where the services are utilised is important. Even if the service is rendered outside India as long as it is utilized in India in a business or profession carried on in India it would be taxable in India as the words used in the statutes does not use the words "fees for services rendered in India" but uses the words "fees for services utilised in India". The AAR also held that there was no difference between fees for engineering services and fees for living allowance and professional fees and the entire income would be taxable in India under section 9(1)(vi) and (vii) of the Act. The importance of place of utilization of service vis-à-vis rendition of service for determining the taxability of FTS and royalty income have now been statutorily recognised by an amendment to section 9(1)(vii) of the Act with retrospective effect from 1976.

Period of Stay: When the Article talks about the period of days, the solar days have to be considered i.e. if five members spent five days in India, it will

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be counted as five days and not 25 days as such multiple counting would lead to absurd results. Further, lawyers representing the firm as employee also comes within the ambit of the term 'member' (See *Clifford Chance UK v. Dy. CIT (2002)(82 ITD 106)(Mum)*).

In *Maharashtra State Electricity Board v. Deputy Commissioner of Income tax [2004] (270 ITR 36) (Mum)*, the taxpayer, a company, intended to enter into a power purchasing agreement with ENRON. The company engaged the services of U.K. based firm of solicitors to assist them in the negotiations for finalization of the agreement with ENRON. The professional fees for the services were to be worked out at an hourly rate plus reimbursement of costs. The total fees inclusive of reimbursement were capped at GBP

900,000. The company took the stand that the payments were covered under Article 15 of the India and UK tax treaty dealing with "Departmental Personal Services" and that as none of the partners of the firm had been in India for more than 90 days the payment for the legal fees were not eligible to tax in India. The AO was of the view that Article 15 was only applicable when the services are rendered by an individual and not when services are rendered by a firm. The AO thus directed the Company to deduct tax on multiple grossing up basis, as the tax was to be borne by the company. The Tribunal held that the services rendered were professional services falling under Article 15 of the DTAA and in the absence of a fixed base and considering that the cumulative stay did not exceed 90 days the legal consultancy fees would be taxable in the hands of the UK solicitor firm only in the UK and therefore, the company was not under an obligation to deduct tax at source.

At times, the tax authorities may hold that the services rendered are more in the nature of fees for included services and therefore ought to be taxed under that Article dealing with 'Royalty/Fees for Included services'. In such cases it will have to be proved based on the services rendered, that the service provided is a 'professional service' rather than a 'technical service'.

A similar issue came up before the Kolkatta Tribunal in the case of *Graphite India Ltd. v. DCIT (2003)(86 ITD 384) (Kol.)* The taxpayer, a company engaged in the business of manufacturing of graphite electrodes, anodes, etc. appointed an individual, resident of the United States of America (USA) as a consultant on retainership basis for improvement and upgradation of the company's products. The consultant was a scientist by profession and in regular employment as Director of Carbon Research Centre, USA. The AO

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directed the company to deduct tax at source on the fees considering the same as Fees for Included Services covered under Article 12(4) of the tax treaty. The Tribunal observed that the services rendered by the consultant were held to be in the nature of professional services as referred to in Article 15, as the work involved, predominantly intellectual (rather than manual) skills dependent on individual characteristics. The Tribunal referred to the definition of the term 'professional services' in the Law Lexicon edited by Justice Y.V. Chandrachud (1997 Edition) and the Black's Law Dictionary (5th edition). The Tribunal therefore held that, in the absence of a fixed base, these services were not taxable in India. However, in the case of *Cedrick Jordan Da Silva vs. ITO (2014)(62 SOT 239)(Pan)*, the Tribunal held that as far as the provisions of section 9(1)(vii) are concerned, merely because a service can be termed as professional service, that fact per se does not take fees for such a professional service outside the ambit of 'fees for technical services'.

The Tribunal has also noted that, in order to be considered as a professional service, the activity should be of an independent character, which includes independent activities of doctors, lawyers and independent teaching, artistic etc. activities. These services should be rendered by an individual or a firm and not a company. The service should not be rendered in the course of employment.

These principles set out by the Tribunal would be helpful in classifying a service as a 'professional service' or a technical service'.

As we have seen this article is wide enough to pull in any independent activity which is capable of generating income.

5.18. Dependent personal services

The UN model reads as under,

"ARTICLE 15 – Dependent Personal Services

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived there from may be taxed in that other State.

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2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

- (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and
- (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State: and
- (c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.”

The following is the extract of para 3 of OCED Model Convention:

Notwithstanding the preceding provisions of this Article, remuneration derived **by a resident of a Contracting State** in respect of an employment, **as a member of the regular complement of a ship or aircraft, that is** exercised aboard a ship or aircraft operated in international traffic, **other than aboard a ship or aircraft operated solely within the other Contracting States shall be taxable only in the first-mentioned State.**

Para 1 - This Para provides that except for income of directors, artists and sportsperson, pension and government service income, the salary will be taxed in the State of residence. This is on the basis that, it is the resident State which has invested in the development of the individual and therefore, it should get the right to tax it. However, considering that the service is rendered and income is generated, the source State it is also given the right to tax the income. This is further spelt out in Para 2.

Income like directors fees, income of artistes and sportsmen etc. are excluded as they are dealt with by special articles and a special article would override a general Article. Perhaps stating this explicitly is also just to avoid confusion.

The place of employment is established by the physical presence and the status of employers comes from a right to instruct the person. The employer-

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employee relationship must be established. One has consider various criteria to determine the employment relationship. Few of the criteria as mentioned in OECD MC (para 8.14) are authority to instruct the individual regarding manner of performing work, control and responsibility of place, right to terminate the arrangement with individual etc. Therefore, if an employee is seconded to another country he would be an employee of the company to which he is seconded. Only if the relationship is established, the income be taxed as salary under this Article. The employer – employee relationship is evidenced by the contract of service and the extent of influence and control over the employee. If the employer can hire and fire, can designate work and fix the remuneration the master servant relationship is established. See the decisions of the Supreme Court in *Lakshmi Narayan Ram Gopal and Son Ltd v. Court of Hyderabad (1954) (25 ITR 449)*, *Piyare Lal Alishwar lal v/s CIT (1960) (40 ITR 17)*.

This Article would cover all income considered as salary including perquisites. The income to be taxed is the “salary” income and “salary” is to be understood as per the domestic law and therefore, in the Indian context, would mean salary as defined in Section 17 of the Act and would include salaries, wages, bonus, pensions etc. The salary income will accrue in the place where the service is rendered. The amounts payable in terms of the employment would be taxable as salary. Refer the decision of the Supreme Court in the case of *Gestetner Duplicators Pvt. Ltd. v. CIT [1979] (117 ITR 1) (SC)*. Further, it should also be noted that the word used in the Models is remuneration which is slightly wider than salary and includes everything like a reward received in connection with the employment. Refer the decision of the Supreme Court in the case of *CIT v. Calcutta Stock Exchange Association Ltd. [1959] (36 ITR 222) (SC)*.

In the case of employees employed in specific industries like oil exploration, where they are required to be posted on rigs which are offshore, the employer provides food and lodging and boarding as it would not be possible for the employee to come onshore and fend for himself. The tax authorities were inclined to tax these amounts as perquisites. The Courts have held that such receipts are not taxable (Uttaranchal High Court - *CIT v. Sedco Forex International Drilling Inc (2003)(264 ITR 320)* and *CIT v. Hyundai Heavy Industries Co Ltd (2003) (264 ITR 328)* and the Gujarat High Court in the case of *CIT v. S.G. Pgnatale [1980] (124 ITR 241)(Guj)*. The logic behind this is that these are not benefits to employee and therefore not a benefit or perquisite as normally understood.

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Para 2 - This para starts with “Notwithstanding the provisions of Para 1”, therefore, though para 1 says that the remuneration can be taxed in the source State. Para 2 restricts the taxability subject to certain conditions being fulfilled. These conditions are basically to establish a nexus with the source State for it to get a right to tax the non-resident. The first condition is that the stay should be for more than 183 days. Some DTAA's specify the period more explicitly as 183 days in any 12 months period commencing or ending in the fiscal year concerned.

The first condition is based on physical presence. The presence here refers to the physical presence. Therefore, in case an employee goes on leave / relaxation, the leave/ relaxation days would not be counted. The same also finds support in OECD MC that entire days spent outside the state of activity whether for holiday, business trip etc. should not be considered (para 5). This is very common in rig-based employees where job cycle is of 25-30 on-days with 25-30 off-days. The issue that would arise is, whether the salary for the leave period or the off- days is taxable in India?

The other conditions are that the remuneration must not be paid by a person who is a resident of the other State and should not be borne by a PE which the employer has in the source State.

In case of employees on ships and aircraft the State of residence would have the right to tax. The salary should not be deductible in the source State, in computing the income of the PE of the employer. This is to avoid giving dual benefit to the employee and the employer. If the State gives a deduction to the employer in arriving at the taxable income, it should have a right to tax the salary.

Therefore, as we have seen above unless an employee satisfies all the conditions the salary would not be taxable in the source State. The conditions prescribed in this para for exemption from tax in the source State are cumulative. This exemption given is popularly known as “short-stay exemption”. The above examination of the conditions prescribed for “short-stay exemption” reveals the importance of determining who the de facto “employer” is and what exactly constitutes “employment”. In this connection, the OECD has clarified the scope of paragraph 2 of Article 15 of the OECD Model Convention by focusing on the interpretation of the terms “employer” and “employment” and also, where the real employer / employment exists in certain situations.

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The OECD states that there are situations where assignees, being on the rolls of non-resident enterprises, have taken “short stay exemption” benefits even though they are actually rendering services in the position of an employee of the resident enterprise.

In such cases, the OECD’s view is that the non-resident assignee would in substance, be the employee of the home country’s resident enterprise and would not be eligible for the “short stay exemption” benefits.

It has also provided guidance to countries that wish to curb the practice of seconding employees which effectively are under their own control and supervision, to a foreign company, and reducing their employee costs by factoring the ‘short-stay’ exemption available to the employees therein, by drafting a proviso to paragraph 2 of Article 15 of the OECD Model Convention on “short stay exemption”, which could be adopted for this purpose.

This proviso states that “short stay exemption” would not be available to the individual if the following two conditions are met namely, (i) the individual renders services in the course of that employment to a person other than the employer who, directly or indirectly, supervises, directs or controls the manner in which the assignee performs these; and (ii) the employer is not responsible for carrying out the purposes for which the assignee performs services. The OECD has suggested that the nature of services rendered by individual in the host country should be an integral part of the business activities carried on by his employer. Therefore, in order to claim the benefit in addition to the conditions prescribed it will have to be established that the service is being rendered to the employer of substance over form.

In recent times with Business Process Outsourcing being the money churning for India and also considering that many multinationals are increasing operations in India this Article has increased importance. This Article also has great relevance for specialized industries like oil and gas which second experts on a regular basis to various countries where their operations are being carried out.

5.19. Other Income

Other income - Under this discussion we shall cover Article 16 - Director’s Fees; Article 17 - Artistes and Sportspersons; Article 18- Pensions; Article - 19 Government Services; Article 20 - Students.

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(i) Article 16 Directors fees – The UN model reads as under: “*ARTICLE 16 – Directors’ Fees and Remuneration of Top – level Managerial Officials*

1. Directors’ fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.

2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.”

Article 16 is an Article for special income. The first para deals with fees received by directors. Para 2 deals with salary income received by top level management.

This Article gives the right to tax the income to the country where the residence of the company is located. This is because that State is going to allow a deduction to the Company in respect of the fee/salary paid and furthermore the employment is exercised therein. The place where the directors’ meetings are held can be said to be the head and brain of the Company. However, this needs to be considered in light of amended definition of residency of company under Section 6. If the Director works in a dual capacity i.e. as a Director as well as top level executive, the compensation if it does not fall under para 1 and 2 of this Article, may have to be split up and considered as salary and director’s fees. If this is not possible, then overbearing function might have to be considered as having importance over others.

In the case of top level management, the salary income is taxed in the country of residence of the company under Article 16, then Article 15 has no operation; as already seen it is subject to the provision of Article 16.

(ii) Article 17 – Artists and sportspersons – Article 17 of UN Model reads as under: “*ARTICLE 17 – Artistes and Sportspersons*

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

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2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself, but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.”

Para 1 – Provides the State in which the activities are performed the right to tax the income therefrom. This is in recognition of the attribution rule and the principle that the source State is giving the means and opportunity to exploit the talent and generate income.

Here entertainment covers all the possible medias of radio, TV, films, theatre, music, sports persons are also covered.

Para 2 provides that when a resident of a State other than the contracting States benefits from the association with the activity performed by the entertainer/sportsmen the jurisdiction of the State will extend to tax such person also. Here the question that may come to one's mind is would this not restrict performers from coming and there by limit cultural exchanges? Cultural exchanges programmes which are inter-government organized would normally might have a waiver on all taxes which may include entertainment and service tax/GST. The OECD contains additional consideration that some countries may consider to exclude from the scope of the Article events supported from public funds.

Implementation of this Article also has practical problems when one considers that most organised programmes are in Orchestras / Groups further complicated by all members not being residents of the same country, as it is possible that person may be resident of one State and exercise employment in the other State. Should revenue and tax sharing certificates given by the organizer be sufficient to claim credit? Should the liability be of the group or should the liability be of the individual would depend on the facts of each case.

Normally, the group payment would be considered unless the arrangement is to pay individually. However, again here the credit in the resident country becomes difficult, unless a certificate of proportionate income and tax if any deducted thereon is issued. Issue also arises the determination when performances of same function are considered in several countries.

Para 2 assumes relevance as today's Artists / sportspersons are managed by companies who take care of their endorsements, arrange performances

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and events. Para 2 provides that the income earned by such company will be taxed in the source State overriding the possibility that Article 7 or Article 14 i.e. the PE or fixed base will be used to tax the income by the source State.

(iii) Article 18 – Pensions and Social Security Payments

“Article 18 (Alternative A)

1. *Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that state.*

2. *Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political sub-division or a local authority thereof shall be taxable only in that state*

Article 18 (Alternative B)

1. *Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.*

2. *However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other state or a permanent establishment situated therein.*

3. *Notwithstanding the provisions of paragraph 1 and 2, pensions paid and other payments made under a public scheme which part of the social security system of a Contracting State or a political sub-division or a local authority thereof shall be taxable only in that State.”*

As can be seen from the above article, post-retirement benefits are generally taxed in state of residence. It can so happen that a resident of one State while rendering service in another State may have contributed to a pension scheme. The UN model's second alternative provides that if the pension is paid by a PE then the State where the PE is located gets the right to tax it. If the pension is paid by the other State, that other State will have the right to tax it. The justification put forth by the source State to tax pension is that it is a form of salary income, which is paid post retirement. Therefore, the justification sought by the source State to collect its share on taxes it contributed to by way of income. Also as a deduction is allowed to a PE there is a justification for the source State to tax it. *In re AAR P.No.12 of 1995*

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[1997] (228 ITR 61) (AAR) it was held that pension received in respect of services rendered in the US when he was a non-resident in India would not be taxable in India as he was a not ordinarily resident.

However, Government pensions are considered under a Separate Article (Article 19)

The word 'pension' in DTAA has also to be given its accepted meaning. Pension in many ways is a consideration for past services rendered which may have been funded by the employee or an employer and employee towards a pension scheme to ensure that old age is taken care of. In case of pension paid to widow of employee, which flowed from past employment of employee, it was held to be exempt whether received by the official himself or his nominee. It was the nature and character of the receipt and not the character of the recipient that would determine the question whether the receipt was exempt from taxation. *CIT v. Smt. Dipali Goswami (1985)(156 ITR 36)(Cal)* refer 'Other Similar Remuneration' would include receipts which are akin to the concept of pension and if specified in the DTAA would include annuity which is also a pre-determined sum payable annually and if specified also gratuity. As we saw earlier the word remuneration includes reward, payment or recompense see *CIT v. Calcutta Stock Exchange (supra)*.

(iv) Article 19 - Remuneration and Pensions in respect of Government Service.

Article 19 of UN Model reads as under

"ARTICLE 19 - Government Service

1. (a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.

(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that state and the individual is a resident of that state who

(i) is a national of that state; or

(ii) did not become a resident of that state solely for the purpose of rendering the services.

2. (a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State

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or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

However, such pension shall be taxable only in the other Contracting state if the individual is a resident of, and a national of, that State.

The provisions of Articles 15, 16, 17 and 18 shall apply to salaries, wages and other similar remuneration, and to pensions in respect of services, rendered in connection with a business carried on by a Contracting State or a political sub-division or a local authority thereof.”

Government Pensions are covered by this Article and they are taxable by the State which pays it. However, where the State is carrying on a business the payments made by the business are not governed by this Article but by the earlier Articles seen i.e. 15, 16, 17 and 18.

Para 1 applies to remuneration and para 2 to pensions. The State which pays the remuneration and pension is given the exclusive right to tax it.

Exception is given to a national of the other state who renders service in the other State i.e. where the local employee becomes a resident solely for the purpose of rendering service to the foreign government.

(v) Article 20 - Students and Apprentices

Article 20 of UN Model reads as under:

“ARTICLE 20 - Students

Payments which a student or business trainee or apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.”

This Article normally exempts the income of a student as the resident State where the student is studying has no nexus to the income and has not contributed to it earning the income. This exception is for income which is received from outside that State.

Some DTAA's may put a ceiling to the income which can be treated as exempt. Further, the amount is supposed to be for the living expenses

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therefore scholarships are also exempt. However any savings on the grants would be taxable [see *CIT v. V.K. Balachandran [1984] (147 ITR 4) (Mad)* in the context of Section 10(16)], it observed that the essence of scholarship is that it should pay for the educational enterprises of a man's pursuit after knowledge. If scholarships are given for such a purpose, it cannot matter whether the recipient is of Indian origin or is of a foreign origin - *CIT v. M.N. Nadkarni [1980] (161 ITR 544) (Bom)*. It was also held in the case of *Dr. V. Mahadev v. CIT [1990] (184 ITR 533) (Mad)* that scholarship received would be exempt (under section 10(16) of the Act). However, scholarship is different from remuneration and if the receipt is in the nature of remuneration which is generally received for the rendering of service it would be taxable. Again here remuneration would cover a wider scope and any reward for service would be taxable as it is different from scholarship.

Certain DTAA's also give a definition to 'student' to make it clear who is to be the beneficiary of the exemption. As far as the stay is temporary and the monies are received for maintenance the remuneration within reasonable limits for a specified period would be exempt. The education referred to is very wide and would technical education or general education.

(vi) Article 21 - Other Income

Article 21 of the UN Model reads as under:

"ARTICLE 21 - Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

3. Notwithstanding the provisions of paragraph 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this

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convention and arising in the other Contracting State may also be taxed in that other State.”

As per OECD model, state of residence is given exclusive right to tax other income. However, UN model, besides right given state of residence, also grants correlative right to state of source to tax other income arising in source state.

This residuary clause is there in a few DTAA's to cover incomes which have not been included in earlier articles or which may not have been otherwise covered to bring every conceivable income within the scope of the DTAA and uphold the principle that no income should be doubly taxed.

Para 1 - This para upholds the right of resident State to tax any income. This is based on the primary concept of residence. Para 1 also uses the positive 'shall be taxable' which is distinct from 'may be taxable' and gives the resident State the right to tax the income. What is also important to note is that word 'taxable' as against 'taxed' has been used therefore as long as it 'taxable' then if that State chooses to exempt it, it is its prerogative.

Para 2 - Contains two exceptions. Both of these are in line with the generally accepted principles of interpreting and giving effect to DTAA. The first part provides that income from immovable property shall be taxed only in the State in which it is situated as that country alone has the right to collect tax. The second part recognises the unique place which a PE or a fixed base has been given in DTAA's and acknowledges that if there is a PE / Fixed base that State and the income is attributable to the PE / fixed base the State where the PE / Fixed place is located alone has the right to tax it.

Para 3 - Recognises the right of a source State and provides that the source State may also tax the income. It is up to the negotiators to the DTAA to specify the terms and conditions under which the source State can tax the income. It is also up to the negotiators whether to keep this Article or not. If in spite of all precautions income is ultimately doubly taxed, tax sparing or credit will have to be given in the State of ultimate liability. In case of Johnson Matthey Public Ltd. Co. V. Dy. CIT (International Taxation) 88 Taxmann.com 127, Delhi Tribunal held that where the assessee provided guarantee to various banks to extend credit facilities to its Indian subsidiaries, the guarantee fee charged it would not fall within expression of 'interest' and in view of clause (3) of article 23 of the India-UK treaty, in absence of any specific provision had to be taxed in India as 'Income from other source'.

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All unconventional and new means of income and financial transactions are covered by this Article. Some of the typical incomes which would get covered are lottery winnings, prize money, gambling income, punitive damages etc. In case of *DLJBM Mauritius (228 ITR 268)*, the AAR held that income distribution by non-corporate funds would be covered by other income. This leads us to the question is this Article good enough to cover E-Commerce? The jury is still out on this one and would depend on whether it is an isolated transaction or can be linked to a PE.

Where passage money is paid to non-resident who came to India to render professional or technical service is it to be taken as part of salary? As we saw earlier there are a host of decisions starting with Supreme Court in *Goslino Mario supra* which say that boarding and lodging is exempt, whether that analogy can be stretched to passage money? Therefore, it can be contended that if the fee is not taxable the passage money is also not taxable. This would follow that either as perks or as salary passage money will have to be grossed up if tax is to the account of the resident.

What is essential is that the service must be rendered in India. If any form of service is rendered outside India and payment is made outside India, it will not be taxable e.g. Commission or fee paid abroad. See *CIT v. Toshokul (1980)(125 ITR 525)* These interpretations become important in the face of stringent TDS provisions. Therefore, it is essential to classify income as taxable or not. It must also be mentioned that the Bombay High Court in the case of *Pfizer Corporation v. ITO (2003)(259 ITR 891)* held that dividend accrued to a non-resident only on remittance. However, if no prior permission is required for remitting the dividend the ruling has limited application.

5.20. Elimination of double taxation

The relief in respect of double taxation can be given by two ways. One is universal relief i.e. given under domestic law of that country, while bilateral relief is given under DTAA, generally governed by article 23.

Article 23A and 23B of UN Model read as under:

“ARTICLE 23A - Exemption method

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived

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by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11 12, and 12A may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income which may be taxed in that other State.

3. Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11, 12 or 12A to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2.

ARTICLE 23B - Credit Method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident, an amount equal to the income-tax paid in that other State; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income-tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where, in accordance with any provisions of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.”

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With DTAA's being a subject matter of negotiation some amount of double taxation may be consciously agreed or unavoidable e.g. incomes which are taxed at concessional rates would normally suffer tax in both countries. However, in keeping with the spirit of avoidance of double taxation, Article 23 provides for relief in respect of doubly taxed income. The relief can be either by exemption method which exempts the income from taxation in the resident State if taxed in the source State or the credit method which allows credit for taxes paid in the source State.

Exemption method

As we saw DTAA's provide concurrent rights to the source State and the resident State to tax the income. In certain cases, like shipping income the State of residence has the exclusive right to tax the income, in case of certain income the State of source has the right to tax, in certain other cases like royalty income the State of Source has a right to tax it at the agreed rate. To avoid double taxation one of the methods are resorted to. In the exemption method, the residence State grants an exclusive right to the source State to tax the income. This method may be applied in two ways:

- (i) full exemption – in this method the residence State does not take into account the income earned in the source State at all while determining the tax to be levied on the global income of the non-resident.
- (ii) exemption with progression- the residence State does not tax the income but takes it into account in computing the total income to be taxed.

Credit method

Under this method the resident State retains its right to tax the income but allows credit/deduction for tax paid in the source State. Under this method the residence State treats the tax paid in the source country as if it were tax paid to itself. This method is also applied in two types:

- (i) full credit – in this method full credit is given for the total tax paid in the source State.
- (ii) ordinary credit- in this method the credit is restricted to the tax which the State of residence would have levied on that income.

Para 1 provides for exemption of tax on the income which has been taxed in the source country. Para 2 deals with certain cases of certain income like dividend interest and royalty (included in the UN model) which both the

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States have a right to tax, credit is given to extent of the tax paid. If however the income is exempt from tax in the source country say like dividend in India, it is nevertheless to be taken into account in computing the income in the resident State. The basic difference in the two Models is that Para 1 of the tax exemption method exempts the income while also providing for credit in respect of doubly taxed income while tax credit method only allows for credit in respect of taxes paid. However, in both Models where income is totally exempt in the source State, it will be considered for rate purposes.

Exemption method exempts income while tax credit method spares tax therefore it is also referred to as 'tax sparing method'. Tax credit takes into consideration the tax actually paid whereas 'tax sparing' is sparing the tax payable. (Tax sparing is discussed in detail later). On account of the difference in taxation laws of each country the tax payable on the same income may differ as rebates and deductions offered are different. Depending on the way the Article is worded the taxable income in the home country, on that income, may have to be worked out against which the credit is allowed for tax paid or the exemptions given in the source country will be ignored and the tax payable will be worked out. Alternatively, irrespective of the tax payable in the home country on that income, credit will be allowed of tax paid in the source country. Therefore there may be total or partial tax sparing depending on whether it is for 'tax paid' or 'tax payable'.

In certain agreements like with USA, credit is allowed of tax paid on dividend by the distributing Indian company against the tax payable on the income of the US company in the respective country. However, to avail of this the US company must hold at least 10 percent of the shares of the Indian company. Similar provision is there in the DTAA with Singapore however the beneficial holding must be atleast 25 percent this is what is known as the 'deemed tax paid credit' or underlying tax credit.

Recently, CBDT has issued rules in respect of foreign tax credit and has also issued a notification for introducing new rule with respect to FTC that came into effect from 1 April 2017.

The term 'tax paid will also be defined to emphasise what should or should not be considered in arriving at the 'tax paid/payable' and would normally be the 'tax paid / payable' without considering the special deductions available against that income in the source State. This would depend on the nature of income for e.g. where certain incomes are taxed at a flat rate no deduction is

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allowed. The exemptions/deductions which are peculiar to that State and which are to be ignored/considered will also be specified. The intention here is to make the taxes payable on par by neutralising the differences. The extent to which it is the done and how administratively it will be handled by each State is decided in negotiations.

The wording's used in the para are "in accordance with the provisions of this Convention" this means that even if there is a difference in classification of the taxpayer or the income in the States, the Source State taxes the income in accordance with the Convention which though they may be different from the provisions which the resident State may have applied the source State's taxation would still be "in accordance with this Convention" and the resident State would be obliged to give credit for taxes deducted irrespective of the quantification applied by the source State. This problem is typical in the case of partnerships where one of the States considers them to be taxable while the other considers them to be fiscally transparent entities. However, if the problem is not of classification of the taxpayer but of the interpretation of the provisions of the DTAA which the resident State does not agree with it is not obliged to grant credit for taxes paid. Such situations may be sorted out through the MAP. E.g. In the case of the Indo-UK DTAA there was dispute on whether partnerships being fiscally transparent entities in the UK are entitled to the benefits of the DTAA. The Competent Authorities were debating the matter however in the meantime so as not to cause any hardship to the taxpayer issued a Memorandum of Understanding (MOU) that taxes should not be recovered till such time the issue is resolved. (Instruction No. 3/20047 dated 19 March 2004)

However if the resident State considers that the income has not been taxed in the source State to prevent double non-taxation it is not bound to exempt the income under para 1 where the exemption method is followed irrespective of whether it itself would have taxed it.

In an interesting ruling in the case of *DCIT vs Tata Sons Limited (ITA No. 4776 / Mum / 04)*, the Mumbai bench of the Tribunal held that the US federal tax and state tax paid in respect of income earned overseas are not deductible as expenditure incurred for earning income under section 37 of the Act. Tribunal further observed that though relief is not available for state income taxes paid under the India- US DTAA, the relief is available under Section 91 read with Section 90 of the Act.

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This is an important ruling from the Mumbai Tribunal, where it has been held that foreign taxes (including state tax) paid by the taxpayer are covered by Section 40(a)(ii) of the Act and therefore not deductible as expenditure while computing taxable income under the Act. This decision was rendered in the context of India-USA DTAA, in terms of which only federal taxes paid in US are eligible for credit in India. The Tribunal also held that state taxes paid in US, which are not eligible for credit under the DTAA, would be entitled to relief under Section 91 of the Act. It is interesting to note that relief under Section 91 seems to be available in respect of income tax paid by the taxpayer in the country with which India does not have a DTAA.

It was held by Ahmedabad Tribunal in case of Dr. Rajiv I. Modi v. Dy. CIT 86 taxmann.com 253 that section 91 does not discriminate between State and Federal taxes, and in effect provides for both types of Income taxes to be taken into account for purpose of tax credit.

Para 2 - As we have seen so far certain Articles in the DTAA allow both the States to impose tax e.g. interest, dividend whereas some Articles make it clear that the source State or the resident State is to levy tax e.g. Income from Immovable property or business income in the absence of a PE. In the latter category there is no double taxation but tax sparing may have to be given in respect of tax paid on the immovable property in the State of residence. In the former there is most definitely double taxation whose effect has to be neutralised. To provide for this Article 23 is introduced. The main feature of the exemption method is that the residence State (Para 1) completely gives up its fundamental right to tax the income in favour of the source State. Under the credit method it retains the right but allow credit for taxes paid. The credit method deals with tax to the extent paid in the source state the exemption method deals with income.

Para 2 in the exemption method is an exception to para 1 and deals with double taxed income like interest, dividend and in some DTAA's royalty. Double taxation is avoided by giving credit for tax paid in the resident country. In the tax credit method the credit is restricted to the tax actually paid which however cannot exceed the amount which would have been payable in the resident State on that income. This is to ensure that the resident State does not lose out on its revenue collections by giving higher tax credits.

Tax sparing - The developing countries in order to attract capital and investment give various concession e.g. In India units located in FTZ or STPs are exempt from tax, other incentives in form of section 80-IA etc are given.

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This may push the effective rate of tax down. If the credit is restricted to the tax paid this concession given to the investor is lost by the resident State getting the benefit of the incentives by collecting the tax paid. To keep this benefit, in fact the resident State agrees to give credit not of tax paid but that which would have been payable in the absence of such incentives. Therefore, the incentive is retained by the investor and the tax incentive is not nullified in the State of residence. Tax sparing goes beyond the pure credit method and takes into account the fictitious tax which would have been payable. In tax sparing method credit may be restricted to ceiling rates therefore; if the tax paid in the source country is lower automatically the incentive is retained by the investor. If the credit is higher than the ceiling rate the resident country also sacrifices some tax collections.

The illustrations in the models are benchmarks however the specific provisions in the DTAA ought to be considered while interpreting the working of the Article. Differences in exemptions given based on the interest of each state difference in treatment of losses, difference in VAT, customs barriers all create multiple and complex problems in the interpretation and application of this Article which have to be sorted out on a case to case basis with respect to domestic law, intention of the DTAA and if required by approaching the Competent Authority.

Illustration of methods in the Models is reproduced below.

Commentaries on U.N. Models would illustrate the principle embodied in two methods as under:

“1. The principle of exemption

Under the principle of exemption, the State of resident R does not tax the income which according to the convention may be taxed in State E or S (nor, of course, also income which shall be taxable only in State E or S).

The principle of exemption may be applied by two main methods:

the income which may be taxed in State E or S is not taken into account by state R for the purposes of its tax; State R is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the rest of the income; this method is called “full exemption”.

The income which may be taxed in State E or S is not taxed by State R, but State R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income; this method is called “exemption with progression”.

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2. The principle of credit

Under the principle of credit, the State of resident R calculates its tax on the basis of the taxpayer's total income including the income from the other State E or S which, according to the convention, may be taxed in that other State (but not including income which shall be taxable only in State S). It then allows a deduction from its own tax for the tax paid in the other State.

The principle of credit may be applied by two main methods:

State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State; this method is called "full credit":

The deduction given by State R for the tax paid on the other state is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State: this method is called "ordinary credit."

Fundamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax."

One point which needs clarification and is often the bone of contention between the tax payer and the tax authorities is whether the rate of tax specified in the DTAA has to be increased by surcharge. The view which is supported by the decision of the Bombay Tribunal in the case of *Bank of America v. DCIT (2001)(78 ITD 1)(Mum)* is that the rate specified in the DTAA is inclusive of surcharge and is not to be increased further. This is also held by Kolkata Tribunal in the case of *DIC Asia Pacific Pte Ltd. vs. ADIT (ITA No. 1458/Kol/2011), dated 20 June 2012*. The other practical reason is also that of one of the States increases the levy by more than what is specified when it comes to tax sparing or arriving at the tax in the other country that other country will have to give up the tax to the extent of the surcharge which would not be fair. The rate to be considered is the rate at which tax would have been payable, if there had been no incentive and not effective rate after incentives so as not to take away the incentives given in one country by the other unless those are already included in the DTAA This view is supported by the decision of *Durametallic (India) Ltd v. ACIT (2003)(85 ITD 442) (Mad)* where the ITAT held that in respect of section 80-O the relief should be on the net amount after relief as the relief has to be on the income which is suffering double taxation and not on the gross amount. Therefore , relief under the DTAA cannot go to reduce the doubly taxed income. Also refer - *Bombay Burmah Trading Corp Ltd v. Asst. CIT (2002)(82*

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ITD 531 (Mum). Further, in case of *Aker Powerage (p.P Ltd. v. Addl. CIT 70 taxmann.com 1*, Mumbai Tribunal held that just because an assessee does not claim double taxation relief in respect of a foreign income, it does not entitle the assessee to exclude that income from the taxable income.

5.21. Limitation of benefits (LOB)

As we saw in Chapter III, DTAA's are used and abused for Treaty Shopping. This is tried to be controlled by ensuring that the benefit is extended to the 'beneficial owner'. Therefore, as we saw most Articles on Interest, Royalty were centered around the 'beneficial owner'. The Article dealing with 'Residents' is also used to limit the benefits of the DTAA to the 'Resident of the Contracting State'. As we saw 'resident' need not mean he pays tax in that State but that he is liable to, either in the present or at a future date. DTAA's are tools for avoidance of double taxation and not avoidance of taxation.

In countries which have no or very low tax rate and which are used as tax havens, a 'look through' clause can be inserted in the DTAA's negotiated by them. A 'look through' clause basically ensures pierces the corporate veil to find out who is the owner of the company and ensures that the DTAA benefit is extended only if the owner is the resident of the Contracting State.

Another tool which can be used is inserting a 'subject to tax provision' which limits the application of the DTAA only if the income is subject to tax in the other State. However, as we have repeatedly seen actual payment of tax cannot be a ground for denying DTAA benefits. Therefore, this tool should be limitedly used as it penalizes honest taxpayers also. However, if certain flexible norms are used to give the benefit in genuine case, perhaps this approach can also be effectively used.

The DTAA's with USA have a more diverse approach to LOB and fighting of treaty abuse. Para 1 of the Article 24 of the Indo-USA DTAA on LOB provides that the benefits of the DTAA will only be available if at least

50 percent of the beneficial holding is by a resident of a Contracting State and provided that the income of the person claiming DTAA benefits is not used to meet the liability of the persons who are not residents of the either Contracting States.

However to ensure again that *bona fide* cases are not targeted various exclusionary provisions may be also used.

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India, has revised its treaty with Malaysia to take effect from 2013, the LoB clause of the said tax treaty reads as under:

- If the affairs were arranged in such a manner as if it was the main purpose or one of the main purposes to take the benefits of this Agreement, then the person shall not be entitled to the benefits of the tax treaty
- Legal entities not having bonafide business activities shall also be covered under the provisions of the domestic law relating to tax avoidance or evasion

Negotiations tookplace with respect to India Mauritius tax treaty *inter alia* with respect to LoB clause, pursuant to which protocol was released (12 May 2016). This protocol *inter alia* contains the following clauses:

- The benefit of 50% of reduction in tax rates in case of capital gains would be available to Mauritius resident in transition period, only if it satisfies the main purpose test and Bonafide business test
- A resident is deemed to be a shell / conduit company, if total expenditure on operations in Mauritius is less than INR 2.7 million (Mauritius Rupees 1.5 million) in the immediately preceding 12 months.

One has to refer the above-mentioned LoB clause as contained in protocol which would be made effective.

General bona fide provision

“The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention”

Therefore, if it can be satisfactorily established that the business is structured in a particular manner out of genuine business considerations the benefit of the DTAA will not be denied.

An issue was raised before Rajkot Tribunal in the case of *ITO vs. MUR Shipping DMC Co, UAE (ITA N. 405/ RJT/2013)* that taxpayer was registered

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in UAE to get the benefit of the tax treaty and it was neither paying any freight in India nor in UAE. The AO invoked the provisions of Article 29 of the tax treaty and declined the tax treaty benefits to the taxpayer.

The Tribunal held that the benefit of the India-UAE tax treaty cannot be denied to the foreign shipping company by applying Limitation of Benefit provisions, since such a company has bonafide business activities in the UAE. The Tribunal held that LOB provisions under the tax treaty would be applicable only when the main purpose or one of the main purposes of the creation of an entity was to obtain benefits of the tax treaty which would otherwise would not be available.

Activity Provision

“The foregoing provisions shall not apply where the company is engaged in substantial business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations.”

This clause ensures that the benefit goes to a resident who is actively engaged in business in the other Contracting State thus demonstrating that it is not a conduit company set up merely for DTAA benefits.

The USA DTAA has specified that the activities cannot include activities of banking, insurance, as these are very susceptible to treaty shopping conduit operations and argue that the company is engaged in substantial business in the Contracting State.

Amount of tax provision

“The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident”

This also indicates that the reason for setting up a company in a particular State is not motivated by the savings in tax and therefore, demonstrates the genuineness.

Stock Exchange Provision

“The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned – directly or through one or more companies each of which is a

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resident of the first-mentioned State- by a company which is a resident of the first- mentioned State and the principal class of whose shares is so registered”

This clause again implies the *bona fides*; even the Indo-USA DTAA Article 24 Para 3 provides for a similar exclusion to provide that where the shares are regularly traded on a stock exchange, all these imply that the company is not a conduit company.

Alternate relief provisions

“In cases, where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term ‘shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation not less favourable than the relief from taxation claimed under this Convention’ ”.

This again demonstrates that the intention behind setting up a company is not to avoid tax.

The Article 24 of the Indo-USA DTAA reads as under:

“ARTICLE 24 – Limitation on benefits

1. A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

- (a) more than 50 per cent of the beneficial interest in such person (or in the case of a company, more than 50 per cent of the number of shares of each class of the company’s shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States; and*
- (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not resident of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities or citizens of the United States.*

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2. *The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).*

3. *The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:*

- (a) *in the case of United States, the NASDAQ System owned by the National Association of Securities Dealers,, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934;*
- (b) *in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contract Regulation Act, 1956; and*
- (c) *any other stock exchange agreed upon by the competent authorities of the Contracting States.*

4. *A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines."*

India-Singapore Comprehensive Economic Cooperation Agreement

The Governments of India and Singapore have signed Comprehensive Economic Cooperation Agreement (CECA) dated 29th June, 2005 to promote mutually beneficial economic relations. The CECA comes into effect from 1st August, 2005. The CECA is the first of its kind for India, paving the way for increased foreign direct investment (FDI) and foreign institutional investment (FII) from Singapore. The existing DTAA between India and Singapore has been amended to provide for sharing of information and improved tax treatment on the lines of the India-Mauritius DTAA. As per the amended DTAA the capital gains arising to a resident of a contracting state from

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alienation of any property (including shares) in the other Contracting State (other than immovable property or property forming part of a Permanent Establishment or the Permanent Establishment itself) will be taxed only in the Contracting State where the alienator is a resident. However, the exemption in the India-Singapore DTAA has a "Limitation of Benefits" clause.

The Limitation on Benefits (LOB) is meant to prevent abuse of the above capital gains tax exemption. The LOB provision, in the CECA, provides as follows:

- A tax resident will not be entitled to the capital gains tax exemption if its affairs are arranged primarily to take advantage of the benefits of the capital gains tax exemption.
- A shell/conduit company (i.e. a company being a resident of a Contracting State with negligible or nil business operations or with no real and continuous business activities in the Resident State) will not be eligible for the capital gains tax exemption.
- A company would not be a shell/conduit company if:
 - It is listed on the recognized stock exchange of the Contracting State; or
 - Its total annual expenditure on operations in that Contracting State is equal to or more than S\$ 200,000 or INR 50,00,000 in the respective Contracting State as the case may be, in immediately preceding period of 24 months from the date the gains arise i.e. date of sale.

Therefore this Article is an important tool to tackle treaty shopping. However, it is also accepted that as long as there is no evidence of treaty abuse the provisions of the DTAA must be given effect to. The 1998 OECD Report also refers to Treaty shopping and mentions that it encourages harmful tax competition. It therefore encourages use of the Article on Exchange of Information to effectively combat treaty shopping and also suggests *inter alia* DTAA's with tax havens should not be entered into/continued with.

All along we have considered treaty shopping from the view point of a person who is a non-resident in the Contracting State. However, it can also be entered into by persons who are residents of the Contracting States. Taxation of foreign income is normally taxed on accrual or on receipt therefore, it may be possible to avoid or defer a tax liability by not bringing the foreign income in this is why countries also keep tight exchange control

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regulations to prevent accumulation of income abroad and also introduce Controlled Foreign Corporation Rules (CFC) to ensure that this does not happen. A CFC is a foreign corporation over whom the residents of a Contracting State have control either in the form of equity or a right to share the profits or assets on liquidation or voting rights. Most CFC regulations include direct and indirect control as well as constructive ownership through third parties. The CFC Rules apply to the attributable income of the company. This income can be sifted out by targeting passive income of these companies in low tax jurisdiction or by hunting out dummy companies registered in known tax havens; the CFC Rules are then made applicable either to these countries or to these incomes or a combination of both. Even the OECD commentary suggests that countries should adopt CFC Rules if they do not already have them or they should adopt them if they don't already have them. CFC Rules are more concerned with domestic taxation and as a measure to combat tax avoidance rather than a vital part of the DTAAAs as they are not incorporated in the DTAAAs. Another issue with CFC Rules is does this lead to economic double taxation with both countries. The resident country, to capture these incomes may introduce deeming provisions to provide that the income which has effectively accrued to the resident outside the resident State is taxable in the resident State irrespective of whether it is actually received. Therefore, where the dividend declared by a parent company is kept with a sub- subsidiary in a tax haven which does not declare it in favour of the subsidiary the resident may deem that dividend which is held abroad to be the income of the resident. This as we saw earlier was also discussed in the Chapter dealing on Tax Avoidance.

Therefore, as we saw the limitation of benefits is a useful tool in combating tax avoidance and Treaty Shopping.

5.22. Non-discrimination

Article 24 of UN Model reads as under:

“ARTICLE 24 - Non- Discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other state in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1,

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also apply to persons who are not residents of one or both of the Contracting State.

2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other state carrying on the same activities. This provisions shall not be construed as obliging a Contracting State to grant to resident of the other Contracting State any personal allowances, relief and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first- mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned state.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more resident of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first- mentioned State are or may be subjected.

6. The provisions of this article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.”

The basic intention of this Article is to ensure that that resident enterprises of a Contracting State doing business in the other State i.e. source State are

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treated fairly therein and on an equal footing as its own residents. Thus, to avoid discrimination against nationals or residents of another contracting state.

Paras 1 and 2 deal with 'nationals' and "Stateless Persons" and provide that taxation and anything connected therewith shall be on an equal footing as with residents/nationals of the contracting State / source State.

Para 1 basically ensures that, all things being equal, the resident and the non-resident will be treated on par under the same circumstance unless there is a good enough reason to deviate. This is in line with the principle of equity. However, differentiation in the rate of tax is not considered as discrimination. The AAR in the case of *In re P No. 16 of 1998 [1999] (236 ITR 103)* held that the foreign bank and the nationalised bank were not carrying on the same activities, the resident banks have different responsibilities and obligations from non-resident banks e.g. a resident bank has to have branches in rural areas, therefore it was felt that a higher rate of tax is justified. This order has been subsequently set aside by the *Supreme Court (251 ITR 657) (2001)* on the technical ground that the AAR had no authority to decide the issue as the issue was pending before the tax authorities on merits. The AAR in case of *Canoro Resources Ltd., In re (2009)(313 ITR 2)* held that the cross border transaction between Indian nationals, where one or both of them are non-residents, and who are AEs, would attract Transfer pricing provisions as they would apply to similarly situated foreign nationals. In another AAR Ruling *(2011)(333 ITR 1)(AAR) - Transworld Garnet Co. Ltd. In Re.*, it was observed that Taxation and tax are not interchangeable. The object clause of every agreement uses the expression "taxation" and "tax" where the purpose is stated to be "avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income or wealth". Further, the expression taxation has been used in article 24. Avoidance of discrimination is the object of the former and the avoidance of double taxation of the latter. Where the rate of tax is the focus, the language used is "tax so charged shall not exceed". The discrimination against taxation therefore means the procedures by which tax is imposed.

The Kolkatta Tribunal in the unreported case of *ABN Amro Bank NV. v. DCIT ITA No.692/Cal/2000 dated 30 March 2001* also held that by virtue of Article 24(2) of the DTAA with the Netherlands, (non-discrimination), the company could not be subjected to taxation in a less favourable manner than that applicable to Indian companies.

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This decision is, however, before the amendment to section 90. Section 90 was amended to insert an *Explanation*, by the Finance Act, 2001, with

retrospective effect from 1 April 1962, to provide that the higher rate of tax charged to a foreign company would not amount to discrimination. (The Finance (No.2) Act, 2004 with retrospective effect from 1st April 1962 has also deleted the requirement that the foreign company should have made arrangement for declaration and payment of dividend out of its income in India to avoid such discrimination). Earlier the amendment was sought to be justified as India did not have the right to tax the dividends declared abroad as; it did not have the right to tax the non-residents abroad, however, with dividend now being tax free in India that argument is no longer completely valid.

However, the Mumbai Tribunal in the unreported case of *ITO v. Decca Survey Overseas Ltd.* (ITA No. 3604/Bom/94 dated 27 February 2004) held that the rate of tax in the case of foreign companies having a presence in India and being taxed on their business profits should be at par with that applicable to an Indian company. The Tribunal noted that the *Explanation* to section 90(2), inserted with retrospective effect from 1st April, 1962, which states that merely because a higher rate of tax has been prescribed for a foreign company, compared to the tax rate for a domestic company, it cannot be construed as discriminating between the two, is hedged by a condition that the foreign company should not have made the prescribed arrangements for declaration and payment of dividends within India payable out of its income in India. The Tribunal considered and accepted the contention of the taxpayer company that the *Explanation* has not been activated by the Legislature by framing rules as to what would amount to the 'prescribed' arrangements for distribution of dividends and therefore, the *Explanation* cannot be applied at all. The Tribunal therefore, held that the *Explanation* thus remained a dead letter and the tax authorities could not place any reliance on it. However, as said above the Finance (No.2.) Act, 2004 with retrospective effect from 1st April, 1962 has also deleted the requirement that the foreign company should have made arrangement for declaration and payment of dividend out of its income in India to avoid such discrimination

Mumbai Bench of the Tribunal in the case of *Credit Llyonnais v. DCIT* [2005] (94 ITD 401)(Mum)) and in case of *ABN Amro Bank NV v. JCIT, ITAT Kolkata Third Member Bench* (2005) (96 TTJ 1041) (Cal)) held that charging

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domestic companies and non-domestic companies at different rates has nothing to do with the nationality which is the base of non-discrimination clause in article 25 of the DTAA. It was also observed by Mumbai in case of *Abu-Dhabi Commercial Bank Ltd. vs. JCIT (2007)(18 SOT 169) (Mum)* that explanation to section 90, charging of higher rate of tax to any foreign company should not be regarded as less favourable charge or discrimination whether the treaty contains any specific provision in this regard or not.

The Mumbai Tribunal, relying on decision in case of *Credit Llyonnais vs. DCIT (94 ITD 401)* held that one does not find any case of discrimination as Indian domestic company and non-resident company fall in two different sets, Within the group (or set) there should not be any discrimination on the basis of nationality - *BNP Paribas Sa (Formerly Known As Banque Nationale De Paris), Appellant vs. DCIT/JCIT (2013)(57 SOT 82)(TBOM)*

It implies that different treatment under different circumstance may be justifiable as differentiation does not mean discrimination. However the line is thin. It is internationally accepted that there will always be two different systems of taxation as no State can tax a person who does business on its soil on his global income. Therefore, there can be one set of rules for a resident and one for a non-resident. Generally, a resident company which pays tax on global income may enjoy some additional benefits whereas non-resident companies which do not pay tax on total income are not necessarily entitled to extra advantages. The discrimination is to the extent of quantum of tax ('more taxation') and taxes other than what nationals are subject to ('other'). However, the reverse i.e. a favorable or less burdensome taxation is not forbidden. This Article however, ensures that discrimination based on nationality is not allowed.

Also, the word used in the article is 'taxation' and not 'levy of tax'; 'levy' means the charge of tax and covers the rate of tax; taxation is of wider import than tax and includes imposition and administration of taxes. When rate of tax is meant to be restricted, the words "tax charged shall not exceed" are normally used (refer articles on royalty, interest etc). The words tax and taxation are different and not interchangeable

The expression any requirement "connected therewith" includes the manner of imposition and collection and assessment of taxes. Here, again differentiation in similar circumstances is not impermissible.

In an interesting ruling by the Mumbai Bench of the Tribunal in the case of *Chohung Bank v. Deputy Director of Income-tax (2006) (286 ITR (AT) 231)*,

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the Tribunal considered the applicability of non-discrimination clause in case of a banking company based at Korea, which had a branch in India carrying out banking activities including financing of foreign trade and foreign exchange transactions. The Korean bank claimed that the tax rate as applicable to Indian companies carrying on similar business should be applied in its case instead of the tax rate applicable to non-resident companies relying upon article 25 of the DTAA between India and South Korea. The Tribunal held that the non-discrimination clause can be invoked only when the foreign entity and Indian entity are carrying on the same activities and not when they are carrying similar activities. It was observed that the Indian banking company has to abide by the additional conditions imposed by Reserve Bank of India such as advances to agriculture, and to weaker sections, which are not done by non-resident banking company. Indian banking companies distribute dividend in India. Dividend is not payable by non-resident banking co. in India. Therefore, it observed that it is not acceptable to compare cooperative societies with non-resident banking companies upon whom there is no such social burden.

Nationality Non Discrimination – (Para 1 and 2) – The word ‘national’ would include natural persons and artificial persons such as a partnership.

A stateless person is one who is resident of either State but may not be national of one.

As we saw earlier ‘nationality’ is the relationship with a State which involves rights and duties and also brings a sense of belonging and allegiance for the individual out of that relationship. The definition of ‘nationals’ is given in the DTAA itself in most DTAA. However, if the definition of national was not included would it be deemed to include a “company” and would that make the Para dealing with PE otiose or does it imply that ‘national’ is restricted to individuals and in the case of a company discrimination is prohibited only when they have a PE? This, in part, was the question before the AAR in *Re P.No.6 of 1995 (1998)(234 ITR 371)(AAR)* in the context of the Indo-UK DTAA. The AAR held that the DTAA prohibited discrimination in two case in the case of individuals and in the case of enterprises having a PE and not otherwise.

Here ‘nationality’ should not be confused with ‘citizenship’ nationality determines the civil rights and duties of a person, all citizens will be nationals but all nationals may or may not be citizens (refer Supreme Court in the case

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of *State Trading Corporation of Indian Ltd. v. CIT AIR (1963 SC 1811)*). The term 'resident' used in the DTAA is also not interchangeable with 'national' as 'resident' is with reference to tax liability whereas a 'national' will have tax liability depending on the physical presence therefore a 'national' of a State will not have liability if he is not physical present in that State.

The AAR in the case of *Ericsson Telephone Corporation of India AB v. CIT (1997) (224 ITR 203)(AAR)* held that 'national' includes a 'company', by virtue of the general definition contained in article 3(1)(g).

Para 2 is extended to 'stateless persons' who must be resident of one of the Treaty States to take advantage of this clause. They have to be resident of at least one to prevent them from exploiting this clause by claiming non-discrimination in both the States. Only individuals can be 'Stateless' as an artificial person gets its status from the State where it is registered. Discrimination based on nationality and not residence is not permitted and that too under similar circumstance.

Para 3 deals with PE and states that taxation of a PE should be on the same footing as a resident enterprise. Here the word "any requirement connected therewith" are absent. The Para also specified that the source State is not obliged to grant any special concessions to the PE which it does not grant to its own residents.

PE Discrimination - As we saw earlier para 3 require a PE to be put on the same footing as a resident Company. In the case of nationals, discrimination is to be concerned with reference to "same circumstances", in case of a PE if is to be considered with reference to "same activities". The activities of the resident and non-resident are to be distinguished if the non- resident is to be put on a more burdensome levy. Here, the residence and activity plays the deciding role and not the nationality 'same' would mean comparable and not identical. The clause and factors is concerned with computation of income and not rate of tax, as we saw earlier in the case of the French bank. All deduction rebates should be uniformly available. Therefore, subject to the specific Articles and application of the arm's length principle deduction of royalty, interest etc. ought to be allowed.

Para 4 provides that, subject to the provisions of the special Articles dealing with interest and royalties, if they are paid by an enterprise it should be allowed a deduction in respect thereof in the same way a resident enterprise would be allowed. Similarly any interest paid should also be allowed.

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Para 5 provides that the enterprise whose capital is held by a non-resident/s shall be treated on par in taxation and connected requirements with enterprises whose capital is held by residents of that State.

Para 6 makes this Article applicable across the board to all taxes notwithstanding provisions of para 2 (Taxes Covered).

Ownership Discrimination - This is more or less on the same lines as PE to ensure that an enterprise is not biased on account of the ownership that against being with non-resident. Here the emphasis is on 'similar enterprise.' This clause ensures that the enterprise is not discriminated because of the ownership and is treated equally as the taxpayers of that State.

The Article is based on the fundamental principle of equality. Discrimination based on residence i.e. that the State is not bound to give extra concessions to non-residents (see para 3) is accepted, though internationally with some reservations, but discrimination based on nationality is not considered at all justifiable.

However, a favoured nation clause is considered acceptable though in a way it is a discrimination against countries that are not so favourably treated. In fact, the protocol to the DTAA may also state that where this is a lower rate say in the case of interest etc. or some other terms in another DTAA are more favorable than the terms listed in that DTAA, that DTAA will be considered as modified to that extent. The reference to which it is to be benchmarked with, is stated in the protocol itself e.g. OECD countries. However differing modes of taxing different entities does not amount to discrimination e.g. Partnership are taxed differently in different countries. It was also held in the case of *Micoperi S. p.A. Milano v. DCIT (2002)(82 ITD 369)(Mum)* that when income is computed under Section 44BB, income is to be determined accordingly and non-discrimination clause does not apply. However, whether non-resident companies can take shelter under this Article against levy of MAT is debatable and it can be argued that presumptive tax falls outside the scope of the DTAA 'taxes covered', however, the AAR in *Re P. No. 14 of 1997 (1998)(234 ITR 335)(AAR)* and *Niko Resources Ltd. [1998] 234 ITR 828 (AAR)* has held that MAT would be applicable even for companies incorporated abroad. Finance Act, 2016, added an explanation in Section 115 JB, to clarify that MAT provisions would not apply to foreign companies, in given situations.

The Pune Bench of the Tribunal in the case of *Daimler Chrysler India Private Limited vs DCIT (2009) (29 SOT 202)* held that the Indian subsidiary of a

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German company was entitled to carry forward accumulated losses under the nondiscrimination provisions of the Germany-India DTAA. This was despite a change in the shareholding of the Indian subsidiary, an event that would otherwise have disentitled a similar company from such a carry forward of accumulated losses on account of section 79 of the Act. The Tribunal observed that given the regulatory framework in India, only a company duly formed and registered under the Companies Act, 1956 could be listed on a stock exchange recognized in India - which would not be possible for the taxpayers' parent German company in that case. Relying on several authorities on international taxation, the tribunal further observed that the taxpayers' parent German company would be similar to a company in which the public is substantially interested if it was listed on a recognized German stock exchange for the purpose of article 24(4) of the Germany-India DTAA. Therefore, it was held by the tribunal, that in view of the provisions of Article 24(4) of the India-German DTAA that the disability on carry forward and set off of accumulated losses on account of change in shareholding pattern, under Section 79 r.w.s 2(18), cannot be extended to the Indian subsidiaries of German parent companies as long as German parent companies are listed on a German stock exchange recognized under their domestic laws. To this extent, the rigour of Section 79 was relaxed due to treaty override.

This decision has been relied upon by Delhi Tribunal in the case of *Mitsubishi Corporation India Pvt. Ltd v. DCIT (I.T.A. No.: 5042/Del/11)* wherein it agreed with the scope of the deduction neutrality clause in non-discrimination provision in the Indo Japan DTAA. It observed that a different treatment to the foreign enterprise *per se* is enough to invoke the non-discrimination clause in the India-Japan tax treaty and in order to establish discrimination, not only that a taxpayer has to demonstrate that he has been subjected to different treatment vis-a-vis other taxpayers, but also that the ground for this differentiation in treatment is unreasonable, arbitrary or irrelevant.

Also, in another interesting ruling by the Mumbai Bench of the Tribunal in the case of *Metchem Canada Inc vs DCIT (2006)(100 ITD 251)(Mum)*, it was held that Permanent Establishments (PEs) can claim deduction of head-office expenditure, without any limits of section 44AC. This decision was in the context of section 44C of the Act and 'non-discrimination' clause of the India-Canada DTAA. In this case, Metchem, a Canadian company, contracted with an Indian company for erection, commissioning and running of a project in India. It claimed deduction for head-office expense in excess

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of limit imposed by section 44C relying on the 'non-discrimination' clause (Article 24) of the India-Canada DTAA.

The Tribunal observed that in the India-Canada DTAA, Articles 24 to 28 appear under the Chapter 'Specific Provisions' whereas Article 7 comes under the Chapter 'Taxation of Income'. Thus, it was observed that Article 7 is a general and Article 24 a special provision. Relying on the maxim 'generalibus specialia derogant' and on the Supreme Court decision in *South India Corporation (P) Ltd vs Secretary, Board of Revenue (AIR 1964 SC 207)* where it was held that 'special things derogate from general things', the Tribunal concluded that provisions of Article 7 should be read as subject to Article 24 and not the other way round. The Tribunal concluded that the restriction placed on deduction of head-office expenditure under section 44C is to be ignored in the light of the provision of Article 24(2) of DTAA. Thus, even though Article 7(4) specifically mandated that deduction of expenses would be allowed according and subject to the provisions and limitations of the taxation law of the source state, such mandate would not apply because article 7(4) itself would be over-ridden by Article 24.

The Tribunal also observed that the applicability of non-discrimination clauses happened to be the subject of controversy. Because of the conflicting views expressed by the Tribunal, a Special Bench was formed. The Special Bench of Ahmedabad vide order dated 04/03/2011 (ITA Nos.1807 & 1978/Ahd/2006 & ITA No.3111/Ahd/2007) in the case of Rajeev Sureshbhai Gajwani (supra), upheld the view taken in the case of Metchem Canada Inc.(supra).

It was observed in this decision that the crux of the decision i.e. the restriction placed on the deduction of head office expenses under section 44C will not be applicable in the case of a Canadian Co. in view of Article 24 contained in the treaty between India and Canada. The decision has been arrived for the reason that Article 24 of the treaty will have precedence over Article 7, which contain deductions of general nature, and if provisions in the Act come in conflict with the treaty, the provisions of the Act are applicable only to the extent they are more beneficial to the assessee; if not, the provisions of the treaty shall prevail.

Delhi High Court in the case of CIT vs. Herbalife International India Pvt. Ltd (Delhi High Court) (ITA 7/2007), dated 13 May 2016 held that Section 40 (a) (i) of the Act (in respect of an AY where requirement of tax deduction in

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respect of payments to resident was not there) is discriminatory and therefore, not applicable in terms of Article 26 (3) of the Indo-US DTAA. The Tribunal decision in this case has been relied upon by Amritsar ITAT in case of M/s. Tyre Plaza Been Hospital, Appellant vs. ITO (I.T.A. No. 546(Asr)/2013, dated 26 September 2013) to hold that because of non-discriminatory cl. 24(1) of DTAA between India and Germany, the foreign national cannot be subjected to provisions of s. 40(a)(i) of the Act.

In conclusion this clause is an essential protection of the principle of equality and human rights. Internationally also it is recognized that a higher burden of tax is also a breach of human rights. There are several unresolved issues e.g. differences in consolidation of profits and set-off of losses rules internationally, differences in rate of tax, taxation of zero tax companies, differences in requirement of information in assessment etc. All these and many more issues need to be sorted out but how there can be a convergence of so many different views and priorities especially between developing and developed countries is anybody's guess.

5.23. Mutual Agreement Procedure

UN Model reads as under:

“ARTICLE 25— Mutual Agreement Procedure” – (Alternative A)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of the Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

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3. *The competent authorities of the Contracting States shall endeavor to resolve any mutual agreement any difficulties or doubts arising as to the interpretation or application of the convention. They may also consult together for the elimination of double taxation in cases not provided for in the convention.*

4. *The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for implementation of the mutual agreement procedure provided for in this Article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above- mentioned bilateral actions and the implementation of the mutual agreement procedure.”*

(Alternative B)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

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4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.

5. Where,

- (a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
- (b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within three years from the presentation of the case to the competent authority of the other Contracting State,

any unresolved issues arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. The arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

Alternative B above is included in 2017 update of UN Model pursuant to BEPS Action Plan 14. Discussion in relation to the Action Plan 14 is given in a separate chapter.

We have seen in the preceding paras that disputes and issues may arise in the implementation of the provisions of the DTAA which is not surprising as DTAA's are also laws in themselves. Any law will tend to be interpreted differently by the taxpayer and by the authorities as the interests are

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conflicting. Indeed if they were not a whole lot of professionals would be redundant! A bit of humour apart as conflicts are inevitable in anything short of a Utopian society hence, the need for this Article.

Para 1 - Where a taxpayer feels that the taxing authority of the Contracting State are / will not be interpreting/interpret the DTAA in keeping with its substance / intention he may approach the Competent Authorities (CA). The case has to be presented before the CA of the State of which the taxpayer is a resident or a national where Article 24(1) applies.

In India, the format of the application and other procedures are prescribed in Rule 44G to 44H of the Rules. Therefore, where an Indian resident feels that the action of the tax authorities of any country is not in accordance with the terms of DTAA, with such other country, he may invoke the mutual agreement procedure by making an application in Form No 34F to the CA in India. Such CA will then take up the matter with their counterpart in the other State involved.

On receiving a reference from the CA of any country, with which India has DTAA, for action taken by the income-tax authority in India which, according to the other State is not in accordance with the terms of DTAA, the Indian CA shall call for and examine the relevant records of the case and give their response to the CA of such country. The CAs of both the Contracting States involved shall endeavor to arrive at a resolution of the case in accordance with the DTAA. (Rule 44H of the Rules).

The Assessing Officer shall give effect to the resolution arrived at under mutual agreement procedure within ninety days of receipt of the same by the Chief Commissioner or the Director-General of Income-tax if assessee accepts the resolution or withdraws the appeal on issue which is subject matter of adjudication under mutual agreement procedure.

Most of tax treaties have time limit for initiating action. The time period is within three years from the first notification of the action resulting in taxation not in accordance with the notification.

This Article is generally criticized with reference to the conditions in this clause as; a taxpayer who is aggrieved should be able to approach the CA of the State where the problem arises and not necessarily through the CA of the State of which he is a national. In fact, even domestic law generally does not discriminate between a resident and a non-resident's right to appeal. Another criticism is with reference to putting a time limit for the application as it may

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not be possible to pin point the exact date and ultimately since it is a remedial provision the time limit should be benevolently considered. The Supreme Court in the case of *Vedabai v. Shantaram Baburao patil [2002]*

(253 ITR 798)(SC) has also held that advancing of substantial justice should be of prime importance.

What is important to understand is that is the 'action' of the tax authority of the other Contracting State that can lead to a grievance, it i.e. the grievance should be a result of somebody else's action and not a unilateral / *suo moto* action. The term refers to all acts or decisions of the tax authorities which the taxpayer feels will result or have resulted in a levy of taxes which are not in accordance with the provisions of the DTAA.

Paras 2 and 3 - Provides for mutual consultation to resolve the issue. The time limit under domestic law has no application.

The CA will first see whether it is worthy of being taken up and then try to resolve the issue itself and give a solution by itself. If that is not possible, they will then approach the CA of the other State. The procedure for bilateral communication is usually set up through diplomatic channels initially and thereafter the CAs may communicate directly. The communication may be through exchange of letter or face to face dialogue usually by meeting in either of the Contracting States alternatively.

The time limit under domestic law is basically not considered to facilitate adjustments of taxes or refunds even after assessment is completed or barred by limitation. The CA plays an important role not only in settling disputes but also giving practical guidelines e.g. if adjustments have to be made to income in country B on account of assessment completed in country A and the assessment has got barred by limitation in Country B the CA may give directions for making the adjustments to the income in Country B.

Also normally the negotiations between the CA are not open to the aggrieved parties though an audience can be requested.

India-USA memorandum of understanding:

India and USA have signed a memorandum of understanding ('MOU') whereby they have agreed on a procedure to defer assessment or suspend collections of taxes during certain negotiations under the India-USA DTAA. The MOU sets out guidelines to defer or suspend taxes including related interest and penalties during negotiations that involve potential or actual tax

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assessments under the MAP article of the Convention. Under the MOU, if assessment is deferred or collection suspended, U.S. and Indian tax authorities may demand security in appropriate cases, as deemed fit and necessary to avoid prejudicing the interests of their respective Governments. The amount of the security demanded may not exceed the amount of additional tax proposed by the Government asking for the security. The amounts of additional tax that can be deferred and suspended under the agreement include, but are not limited to:

- tax demands resulting from pending tax audit or appeal proceedings;
- tax demands as a result of a tax assessment or re-assessment, or on a review by an income tax commissioner; and
- withholding taxes on income or other similar advance taxes that are the subject of MAP proceedings for prior, current, or future years.

The MOU gives the CAs two years to resolve or close the cases, with the start time being the date one authority notifies the other that an application for MAP assistance has been received. The MOU also covers what would be considered acceptable security during the MAP negotiations.

Para 4 - Provides for the CA to arrive at a workable solution which may be either bilateral procedures, conditions, method or unilateral solutions which may also be in addition to bilateral solutions to facilitate the implementation of the solutions.

The MAP prescribed is in addition to the recourses available under domestic law. In India there is the AAR which can be approached before the transaction idea is undertaken to be clear on how the applicable provisions of the DTAA will be interpreted. In case the tax payer does not wish to approach the AAR the matter can also be taken up in regular appellate proceeding through the hierarchy of appellate authorities starting from the AO to the Supreme Court. However, in case of certain issues the MAP may be the best resource as they would be conversant with the intention of the DTAA, the negotiations and bargaining which lead to the wording of the DTAA in its final form. Besides if it is an issue which requires difference in recognition of tax treatments by two countries which can only be resolved by an amendment Notification to the DTAA the MAP is the only solution as no Contracting State can unilaterally amend a DTAA e.g. if the partnership is not a taxable entity in the resident State should the source State recognise the partnership as a taxable entity entitled to DTAA benefit? If the source State is

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not inclined to do so , approaching the CA would be one of the better solutions.

This Article is also important as with emerging method of doing business and technology the provisions may also have to be re-looked at. Further, it is not possible to envisage and provide for every situation that may arise at the time of negotiating the DTAA, therefore the powers are delegated to the CA to decide on issues which arise subsequently. This procedure is in addition to and not as a substitute to remedies under domestic Courts / Tribunals as also noted by the Andhra Pradesh High Court in the case of *CIT v. Visakhapatnam Port Trust (1983) (144 ITR 146) (AP)*. The CA are not bound to and in many cases may not be able to come to an agreement, in that case it is open to the tax payer to approach the domestic appellate authorities. Please note that the MAP can be resorted to even before an order is issued by the AO in case the tax payer feels that the AO's action may be prejudicial to the DTAA's intention or even when the matter is pending before the Tribunal or any appellate authority. In fact, if the order is passed before the CA arrives at their decision the tax payer ought to follow the hierarchy under domestic law. However, practically this may not happen as the domestic appellate authorities may be inclined to stay the hearing of the appeal and await the order of the MAP. If there is an existing order of the appellate authority the CA is not bound to follow it. However, whether this would amount to contempt of Court will depend on the constitution of each country. If the two decisions are at odds with each other, as per principles of natural justice, the taxpayer can adopt the order more favourable to him. In the converse if the order of the MAP is against the taxpayer he is open to take up the matter in appeal under domestic law. However, there might be the danger that the order of the MAP may have an influence on the minds of the appellate authorities.

The Delhi Tribunal in the case of *eFunds Corporation vs ADIT (2010) (42 SOT 165) (Del)* made some interesting observations on the relevance of MAP proceedings. In the facts of this case, since MAP resolution was achieved by the taxpayer and tax authorities in the assessment year 2003-04, the same was followed by the Tribunal for deciding the taxability in the preceding as well as succeeding years.

In this regard, the Tribunal observed that it cannot be assumed that facts of the years under appeal are different from the MAP years or any of the facts were not considered by the competent authorities. It was observed by the

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Tribunal that the competent authorities have not only provided for the computation of income but also for the tax credit to be provided to the taxpayer in the US. Since the taxpayer has not been able to point out any change in the business model as compared to those in MAP assessment years, the Tribunal held that it is clear that the taxpayer has a PE in India in accordance with the MAP resolution. Thus, after observing that there are no changes in the business model in the other years vis-à-vis MAP year, the Tribunal felt it proper to apply MAP resolution of one year to other years.

Bombay High Court in the case of UPS Worldwide Forwarding Inc. (UPS Worldwide Forwarding Inc. v. ADIT/DIT - Writ Petition No. 1455 of 2013) held that MAP initiated on the taxpayer for deferment of assessment proceedings and suspension of collection of taxes for past year would also cover subsequent year under the India-USA tax treaty.

The use of the MAP is limited in case of trilateral ventures. However, in case of controversial issues like the questions of whether higher rate of tax is discriminatory (as we saw earlier in the case of *Societe Generale v. CIT AAR P.No.16 of 1998* earlier in the commentary on Article 24 on Non-discrimination) or whether MAT is applicable to non-resident companies would perhaps have had a more pragmatic result if the CA had been referred to. However, this approach does not seem to be the preferred choice perhaps because the CA takes too long to decide or perhaps because it is not the natural first choice. Taxpayers should be consciously aware that this is a recourse available to them which is worthy of being exploited as the negotiators or their descendants, negotiating the DTAA's are best equipped to interpret it. Perhaps, there may also be an apprehension that the CA may not be willing to take up the issue in bilateral negotiations as the CA are not bound to take up every application made to them. The Delhi Tribunal in the case of *Cable News Network LP, LLLP vs .ADIT (2010)(129 TTJ 177)* (Del) was dealing with an issue of whether an order under section 154 passed consequent upon the resolution under section 90 of the Act, read with article 27 of Indo-US DTAA in order to give effect to the MAP (MAP) was appealable. It was held that it was an order under section 143(3) in which the income of the assessee had been computed by giving effect to resolution under section 90 and such an order was amenable to appeal before the Commissioner (Appeals) under section 246A(1)(a). The Klaus Vogel has noted that in Germany in fact the taxpayer can appeal against the decision of the CA not to take up its case. Though this leads to unending litigation it is in keeping with the recognition of right to appeal if aggrieved.

The Arbitration Convention

Due to the uncertainties associated with MAPs, the members of the European Community ('EC') have entered into the Arbitration Convention to seek recourse on matters relating to double taxation caused by non-observance of the arm's length principle. The Arbitration Convention is considered superior to MAPs to the extent that it is obligated to arrive at a definite solution to the tax dispute presented before it.

5.24. Protocol to DTAA's

The protocol to DTAA's appears at the end, after all the Articles. The protocol is used to explain the terms used in the DTAA and, the intention of the provisions or to elaborate on the treatment intended to be given. Normally, before a DTAA is finalised there are a series of letters exchanged between the Contracting States setting out objections if any to a proposed Article or seeking clarification on a particular Article. This ultimately culminates into the DTAA. Sometimes few of these letters may also form part of the DTAA or there may be a technical explanation as in the Indo-US DTAA. These also form part of the DTAA and are useful in interpretation of the DTAA. Further additions to the Protocol or a Notification are also used to amend or update the provisions of the DTAA.

However, here also the issue of validity of retrospective amendments is an open question. A DTAA is an agreement between two governments and is a contractual understanding based on which a tax payer would have planned his affairs could it be said that there is a promissory estoppel which prevents the government from charging the terms of the contract? The Tribunal in the case of *Tata Iron and Steel Co. v. DCIT [1998] 62 TTJ 17 (Mum)* held that the protocol to DTAA was not applicable to contracts executed prior to the date of ratification. The case pertains to the assessment years 1985-86 and 1986-87. Under the provisions of the DTAA between India and the Federal Republic of Germany entered into under the Indian Income-tax Act, 1922 and ratified under the 1961 Act, "Royalties and FTS" were exempt from tax incidence in India. The DTAA was subsequently amended and "Royalties and fees for technical services" were made taxable. The protocol, introducing these amendments, was ratified on 10th July 1985 and was notified on 26th August 1985. Under the amended protocol, the tax could be imposed on "Royalties and fees for technical services" paid to German residents. The taxpayer-Company had entered into separate agreements with three German

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companies prior to the date of ratification of the protocol and part payments was made to these companies during the financial years 1984-85 and 1985-86. The taxpayer contended that as the agreements were entered into prior to the date of ratification, the payments would not be subject to any tax incidence in India.

Similarly, the Mumbai Tribunal in the case of *Abu Dhabi Commercial Bank Ltd. vs. ADIT (2012)(138 ITD 83)(Mum)* held that the amendment brought by way of protocol amending article 7(3) will not have retrospective effect.

It was held that a subsequent Protocol / Notification cannot be given retrospective effect. The Notification in this case related to tax which became payable on technical services as a result of change in DTAA by Protocol which was followed by a Notification. The Department moved a rectification application under section 254(2) before the Tribunal, against this order. The High Court, in case of *Tata Iron & Steel Co. Ltd. (2001)(116 Taxman 403)(Bom)*, dismissed the appeal, holding that the said decision of the Tribunal that the amendment would not apply to contracts executed before notification had never been challenged by the Department.

A protocol is an essential part of DTAA and the relevant Article must be read along with the explanation there to contained in the protocol. The Supreme Court also took due cognizance of the protocol appended to the India-Japan DTAA in its landmark ruling of *Ishikawajima-Harima Heavy Industries Ltd vs DIT (2007) (158 Taxman 259)(SC)* to elaborate on the meaning of profits indirectly attributable to the PE of the foreign enterprise.

6

TRANSFER PRICING

6.1 Introduction

With the increasing globalisation of trade, companies previously confined to their domestic markets have expanded rapidly to become multinational groups with subsidiaries and affiliates in almost all developed countries and in many of the emerging markets. As a result, it is estimated that significant percent of cross-border trade is between related (i.e., having some common thread of ownership or control) parties. The prices charged between related parties in relation to goods, services, intangibles, loans as well as cost contribution arrangements are considered within the broad term 'transfer pricing'. Transfer pricing norms are used to arrive at the independent price that would have been charged between independent parties, the object being to ensure that there is no suppression of profits or increase of loss in any tax jurisdiction. Transfer Pricing is thus an anti-tax avoidance tool to curb and capture tax avoidance across nations.

Transfer pricing has quickly developed into one of the most important and complex tax issues facing modern businesses today. Taxation authorities worldwide are investigating transfer pricing arrangements with increased vigour. Also the way modern businesses operate emphasises the importance of transfer pricing as an essential part of business planning and strategy. Enterprises would like to source materials and services from the best source and at the best price possible. Between related enterprises the price may be marked lower than or higher than the market price. To ensure that there is no loss of revenue to the State, transfer pricing provisions have been introduced by most countries in their tax code.

As the integration of national economies and markets has increased substantially in recent years, there is a resultant strain on the international tax framework, which was designed more than a century ago. The current rules have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting (BEPS). Thus, all OECD and G20 countries have worked together on an equal footing to design common responses to international

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tax challenges and the comprehensive Action Plans on BEPS is the culmination of these efforts.

The Indian Transfer Pricing regulations were introduced in the Act with effect from 1st April 2001.

Prior to this amendment, a limited provision existed in the Act¹, which provided for making adjustment to the income of a resident taxpayer from a transaction with a non-resident, if the AO was of the view that the income from such a transaction was understated in the hands of the resident due to the close connection between the two. No other rules or obligations about maintenance of documents in relation to such transactions existed under the erstwhile provisions, which remained in the statute for a number of years though it was almost never invoked in practice.

The current transfer pricing regulations are largely in line with international norms and prescribe methodologies to be followed, documentation to be maintained and penalties to be levied, though in some respects they have their own peculiar flavour. The central theme of the provisions, like in most regulations, is the arm's-length principle, which requires charging of an arm's-length-price for all international transactions between associated enterprises, supported as such by appropriate documentation. Over the last decade and a half, these transfer pricing regulations have evolved and now even specified domestic transactions are covered under the purview of transfer pricing provisions. In its effort to align its transfer pricing provisions with the global best practices, India, in the Union Budget 2016, has adopted the three-tier Transfer Pricing Documentation structure [including master file (MF), local file (LF) and country-by-country report (CbCR) as recommended by OECD's BEPS Action Plan 13.

6.2 International transaction

The term "international transaction" is defined in section 92B of the Act and "transaction" is defined in section 92F(v) of the Act.

A transaction is defined to include an arrangement, understanding or action in concert whether or not it is formal or in writing or whether or not it is intended to be enforceable by legal proceedings.

The term 'international transactions' covers a wide range of revenue and capital transactions between two or more associated enterprises, where

¹ Section 92 of the Act

either or both are non-residents. The term also includes arrangements between associated enterprises for sharing costs in connection with benefits, services or facilities provided to any of such enterprises. Basically, any transaction having an impact on the profits, income, losses or assets of the enterprises are intended to be covered by the Transfer Pricing regulations. Therefore, transactions of purchase, sale or lease of tangible or intangible property, lending or borrowing money or any other transaction which can have an impact, as stated above, will be covered. Again, transaction involving provision of services like technical services, sharing of overhead costs between branch and head office, sharing of research and development costs are also covered within the ambit of Transfer Pricing Regulations.

To clarify on the term 'international transactions' and 'intangibles', the Finance Act, 2012 inserted the following Explanation after section 92B(2), with effect from 1st April, 2002:

- the expression "international transaction" shall include -
 - the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing;
 - the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents trademarks, licenses, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;
 - capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;
 - provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;
 - a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact

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that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date;

- the expression "intangible property" shall include -
 - marketing related intangible assets, such as, trademarks, trade names, brand names, logos;
 - technology related intangible assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how;
 - artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings;
 - data processing related intangible assets, such as, proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;
 - engineering related intangible assets, such as, industrial design, product patents, trade secrets, engineering drawing and schematics, blueprints, proprietary documentation;
 - customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders;
 - contract related intangible assets, such as, favourable supplier, contracts, license agreements, franchise agreements, non-compete agreements;
 - human capital related intangible assets, such as, trained and organised work force, employment agreements, union contracts;
 - location related intangible assets, such as, leasehold interest, mineral exploitation rights, easements, air rights, water rights;
 - goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value;
 - methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;
 - any other similar item that derives its value from its intellectual content rather than its physical attributes.

The term international transaction is not necessarily synonymous with cross-border transactions. For instance, even transactions occurring within the territorial limits of India are covered within the ambit of Transfer Pricing Regulations where they are entered into between the Indian branch (non-resident) and Indian subsidiary (resident) of the same foreign company. Again, where an Indian taxpayer enters into a transaction with its foreign branch (resident for India tax purposes), then even though this transaction is cross-border, it shall not be covered in the ambit of Transfer Pricing Regulations as this is a transaction between residents.

Additionally, another type of international transaction is a 'deemed international transaction' as defined in section 92B(2) of the Act. In this context, even though the transaction is between an enterprise and an unrelated enterprise, since there is a prior agreement between the unrelated enterprise and the associated enterprise or the terms of the transaction are determined in substance between such unrelated enterprise and the associated enterprise, Transfer Pricing provisions are applicable to this transaction. To illustrate, if X has entered into a transaction with a non-associated person, say A Ltd. and there exists a prior agreement in relation to this transaction between A Ltd. and Y (an associated enterprise of X); or the terms of this transaction are determined in substance between A Ltd. and Y, then the transaction between A Ltd. and X would be deemed to be an international transaction. In this regard, the enterprise or the associated enterprise shall be a non-resident, irrespective of whether such unrelated enterprise is a non-resident or not. To further illustrate, X or Y or both of them may be non-residents and A Ltd., in the present case, may or may not be a non-resident.

6.3 Associated Enterprises

The term 'associated enterprise' is one of the most important concepts in this Chapter. This term has been defined in section 92A(1) of the Act in a broad manner, the underlying emphasis being on participation in management or control or capital. To illustrate, X and Y would be associated enterprises, if:

X participates, directly or indirectly, or through one or more intermediaries, in the management, control or capital of Y; or

The same persons participate in the management, control or capital of X, as also that of Y.

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To clarify as to how two or more enterprises could be said to be associated due to management, control or capital, the Act also specifies instances in section 92A(2) under which such enterprises would be deemed to be associated. To illustrate, X and Y would be deemed to be associated enterprises if at any time during the previous year:

- X holds, directly or indirectly, shares carrying at least 26 percent voting power in Y or vice versa; or
- Any person holds, directly or indirectly, shares carrying at least 26 percent voting power in both X and Y; or
- A loan advanced by X to Y amounts to at least 51 percent of book value of the total assets of Y or vice versa; or
- X guarantees at least 10 percent of the total borrowings of Y or vice versa; or
- More than half of the directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of X are appointed by Y or vice versa; or
- More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board of X and Y are appointed by the same person(s); or
- The manufacture/process of goods/articles by, or business of, X is wholly dependent on use of intangibles such as know-how, patents etc., or any other commercial rights of similar nature, or any data, documentation or drawing etc., owned by Y or for which Y has exclusive rights; or
- At least 90percent of raw materials for the manufacture or process of goods or articles required by X are supplied by Y or persons specified by Y under commercial terms influenced by Y; or
- Goods/ articles manufactured/ processed by X are sold to Y or persons specified by Y, and Y influences the commercial terms relating to the sale; or
- X is controlled by Mr. A and Y is controlled by Mr. A or relative(s) of Mr.A either individually or jointly; or

- X is controlled by a Hindu Undivided Family², and Y is controlled by a member of such Hindu Undivided Family or by a relative of a member of such Hindu Undivided Family, or jointly by such member and his relative; or
- X is a firm, association of persons or body of individuals, and Y holds at least 10 percent interest in such firm, association of persons or body of individuals; or
- There exists, between X and Y, any relationship of mutual interest, as may be prescribed³

To summarise, the provisions cast a wide net and apply to all multinational and transnational corporations with a presence in India as well as Indian companies with a presence overseas and applies to all types of transactions between them.

6.4 Specified domestic transaction

Transfer pricing regulations have been extended vide Finance Act 2012 to include transactions entered into with domestic related parties or by an undertaking with other undertakings of the same entity for the purposes of section 40A, Chapter VI-A and section 10AA of the Act. Domestic transfer pricing provisions are applicable from Assessment Year 2013-14 onwards.

The term 'specified domestic transaction' or SDT is defined in section 92BA of the Act. It includes the following transactions:

- ****⁴;
- any transaction referred to in section 80A;
- any transfer of goods or services referred to in sub section (8) of section 80-IA;
- any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA;
- any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable;

² A family unit under the Hindu Law assessed separately under the Act

³ No such relationship has yet been prescribed till date

⁴ Omitted by Finance Act, 2017 (w.e.f. 1-4-2017)

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- any business transacted between the persons referred to in sub-section (4) of section 115BAB⁵;
- any other transaction as may be prescribed,

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of INR 20 crore.

6.5 Arm's-length price

The regulations require any income arising from an international transaction with an associated enterprise must be computed having regard to the arm's length price (section 92(1) of the Act). Further, costs or expenses allocated or apportioned between two or more associated enterprises should be determined having regard to arm's-length prices (section 92(2) of the Act). The regulations also require any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the SDT must be computed having regard to the arm's-length price. The transfer pricing provisions would, however, not apply in cases wherein the application of arm's-length price results in a downward revision in the income chargeable to tax or upward revision in the losses in India.

The term arm's-length price has been defined in Section 92F(ii) of the Act as a price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. That is to say, the transaction between associated enterprises should be at a price at which non-associated enterprises would transact.

6.6 Computation of arm's-length price

The arm's-length price in relation to an international transaction or SDT is to be determined using the most appropriate method out of the specified methods, having regard to the nature or class of transaction or class of associated persons or functions performed by such persons or other relevant factors prescribed in Rule 10C. The methods specified under the Act are:

- Comparable Uncontrolled Price Method (CUP);
- Resale Price Method (RPM);
- Cost Plus Method (CPM);

⁵ Inserted by Taxation Laws (Amendment) Act, 2019, w.e.f. 1-4-2020

- Profit Split Method (PSM);
- Transactional Net Margin Method (TNMM) and
- Other method as prescribed under Rule 10 AB

The methods prescribed in the Indian Transfer Pricing Regulations are consistent with the methods prescribed in the OECD Transfer Pricing Guidelines.

Comparable Uncontrolled Price Method⁶

This is a transfer pricing method that compares the price in an international transaction between associated enterprises with the price charged or paid in a comparable uncontrolled transaction. Uncontrolled transaction as per Rule 10A means a transaction between enterprises other than associated enterprises, whether resident or non-resident.

This method makes direct price comparisons between property/ services sold to associated enterprises and unrelated parties. The price so determined is adjusted to account for differences, if any, between the controlled international transaction and the uncontrolled transaction or between the enterprises entering into such transaction, which could materially affect the price in the open market.

Though this method is preferable since it directly focuses on the price of the transaction being tested, it is not usually applied considering the difficulty in finding comparable prices and making adjustments to them before their application. Generally, reliable prices of most products/ services are not available in public domain as price data is confidential and sensitive information which for obvious reasons a company would not like to divulge. Even if the prices are available, they in most cases are not directly comparable with the price of the transaction being tested as factors such as quality, regional and timing differences shall have an impact on the comparability. CUP method mandates a very high standard of comparability between the uncontrolled transaction and the controlled transaction and considering that completely homogeneous uncontrolled prices are difficult to obtain, CUP method remains elusive in most Transfer Pricing Documentation.

⁶ Rule 10B(1)(a) of the Rules

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Resale Price Method⁷

This transfer pricing method is typically used in cases where the property or services are purchased by the taxpayer from an associated enterprise and are resold to an unrelated enterprise. The resale price is reduced by the amount of normal gross profit margin accruing to the taxpayer or to an unrelated enterprise from the purchase and resale of the same or similar property/ services, in a comparable uncontrolled transaction. The price so arrived at is reduced by expenses incurred by the taxpayer in connection with the purchase of the property/ services, to arrive at the inter-company purchase price of the product from an associated enterprise. The price may be further adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market. This method is applicable to marketing operations where the distributor does not perform any value-add to the products being distributed.

Cost Plus Method⁸

This transfer pricing method arrives at an arm's-length price considering the costs incurred by the taxpayer in producing property or provision of service to the associated enterprise. An appropriate gross profit mark-up, arising from the production of the same or similar property or provision of same or similar services by the taxpayer or by unrelated enterprise, in a comparable uncontrolled transaction is then added to such costs to arrive at the arm's-length price. In arriving at the appropriate gross profit mark-up, due adjustments may be made to take into account functional or other differences between the international transaction and the comparable uncontrolled transactions, which could materially affect such profit mark-up in the open market. The difficulty in this method is to find products of the same basic category if not identical and which have substantially similar market targets. Again, this method stipulates broader functional comparability between the taxpayer and the comparable uncontrolled transaction.

⁷ Rule 10B(1)(b) of the Rules

⁸ Rule 10B(1)(c) of the Rules

Profit Split Method⁹

This transfer pricing method is mainly used in case the transactions involve transfer of unique intangibles or in cases where there are multiple transactions amongst associated enterprises, which are so interrelated that they cannot be evaluated separately. This method combines the net profits of the associated enterprises from all such transactions. The relative contribution made by each such associated enterprise, including the taxpayer, to the earning of such profits is then evaluated on the basis of functions performed, assets utilized and risks assumed by each enterprise, and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. The combined profits are then split amongst the enterprises in proportion to their relative contribution which is then taken into account to arrive at an arm's-length price.

Further, the provisions also provide that the combined net profit may, in the first instance, be partially allocated to each enterprise to provide it with a basic return with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution.

Transactional Net Margin Method¹⁰

This transfer pricing method compares the taxpayer's net profit margins (computed in relation to costs incurred or sales effected or assets utilised by the taxpayer or in relation to any other relevant base) realised from an international transaction entered into with an associated enterprise with the net profit margin realised by the taxpayer or by a non-associated enterprise from a comparable uncontrolled transaction in relation to the same base. In arriving at the net profit margin from a comparable uncontrolled transaction, due adjustment may be made to take into account differences between the international transaction and the comparable uncontrolled transactions which could materially affect the amount of net profit margin in the open market.

The TNMM is the most widely used method for ascertaining compliance with the arm's length standard considering that this method stipulates relatively

⁹ Rule 10B(1)(d) of the Rules

¹⁰ Rule 10B(1)(e) of the Rules

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lower levels of comparability between the uncontrolled transaction and the tested transaction, as compared to other methods.

Other method as provided in rule 10AB¹¹

The 'Other Method' shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

Under the other method, the standards of comparability are flexible as compared to CUP method. Further, the other method gives consideration to the price that would have been charged or paid for same or similar transaction under similar circumstances. The other method does not necessitate an actual transaction but it recognizes an analysis which demonstrates independent behavior i.e. which would be agreed between two independent enterprises. Thus, the other method gives credence to the concept of hypothetical arm's length test.

Factors establishing comparability

The Rules prescribe certain attributes which should be referred to for establishing comparability of the uncontrolled transaction with the controlled transaction¹²:

- the specific characteristics of the property transferred or services provided in either transaction;
- the functions performed, taking into account assets employed or to be employed and the risks assumed, by respective parties to the transactions;
- the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions; and
- conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and government orders in force, costs of

¹¹ Rule 10AB of the Rules

¹² Rule 10B(2) of the Rules

labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

Use of multiple years' data

For establishing arm's length comparability, uncontrolled transaction should relate to the same current year in which the international transaction or SDT was entered into¹³.

However, where RPM, CPM or TNMM is used as the most appropriate method for the determination of arm's-length price of international transactions or SDT entered on or after 1 April 2014, the data to be used for analyzing the comparability of an uncontrolled transaction with an international transactions or SDT shall be

- data relating to the current year; or
- data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income for the current year¹⁴.

Further, as per the proviso to rule 10B(5) of the rules, where the data relating to the current year is subsequently available at the time of determination of arm's length price of an international transaction or SDT during the course of any assessment proceeding for the assessment year relevant to the current year, then, such data shall be used for such determination irrespective of the fact that the data was not available at the time of furnishing the return of income of the relevant assessment year.

Factors affecting determination of the most appropriate method

The most appropriate method is the one, which is best suited to the facts and circumstances of the international transactions or SDTs, and which provides the most reliable measure of an arm's-length result in relation to the international transaction or SDT. The provisions enlist certain factors, which should be taken into account in selecting the most appropriate method¹⁵ :

- the nature and class of the international transaction or SDT;
- the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account

¹³ Rule 10B(4) of the Rules

¹⁴ Rule 10B(5) of the Rules

¹⁵ Rule 10C(2) of the Rules

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assets employed or to be employed and risks assumed by such enterprises;

- the availability, coverage and reliability of data necessary for application of the method;
- the degree of comparability existing between the international transaction or SDT and the uncontrolled transaction and between the enterprises entering into such transactions;
- the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction or SDT and the comparable uncontrolled transaction or between the enterprises entering into such transactions; and
- the nature, extent and reliability of assumptions required to be made in application of a method.

Range Concept and Arithmetic mean

The regulations¹⁶ require that where more than one price is determined by the most appropriate method, the arm's-length price shall be computed as follows:

Application of the range concept

- A minimum of six comparables are required in the dataset for applicability of range.
- An arm's length range beginning from the thirty-fifth percentile of the dataset (arranged in ascending order) and ending on the sixty-fifth percentile will be considered.
- A dataset shall be constructed by placing the prices/data in an ascending order.
- If a comparable has been identified on the basis of data relating to:
 - a) Current year, then the data for the immediately preceding two financial years can be considered, provided the comparable has undertaken the same or similar comparable uncontrolled transaction in those preceding two years.
 - b) Financial year immediately preceding the current year, then the data for the immediately preceding two years can be considered

¹⁶ Rule 10CA of the Rules

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provided the comparable has undertaken the same or similar comparable uncontrolled transaction in that preceding year.

Companies may not be considered as comparables, if they have not undertaken comparable uncontrolled transaction in the current year. A company shall be rejected from the comparable data set even if, such an enterprise had undertaken comparable uncontrolled transaction in either or both of the financial years immediately preceding the current year.

Use of weighted average to compute Arm's length price

The price in respect of comparable uncontrolled transactions shall be determined using the weighted average of the prices/data for;

1. the current year and preceding two financial years; or
2. two financial years immediately preceding the current year (but not including the current year as the same may not have been available)

in accordance to the following:

- Where the prices have been determined using RPM, the weighted average of the prices shall be computed with weights being assigned to the quantum of sales.
- Where the prices have been determined using CPM, the weighted average of the prices shall be computed with weights being assigned to the quantum of costs.
- Where the prices have been determined using TNMM, the weighted average of the prices shall be computed with weights being assigned to the quantum of costs incurred or sales effected or assets employed or to be employed, or as the case may be.

Range will not be applicable in cases where the most appropriate method is selected to be the profit split method or the 'other method'.

If the price at which the international transaction or SDT is undertaken is within the thirty-fifth percentile to sixty-fifth percentile of the dataset, the transaction shall be deemed to be at the arm's-length price.

If the price at which the international transaction or the SDT is undertaken is outside the arm's length range (thirty-fifth percentile to sixty-fifth percentile of the dataset), the arm's-length price of the transaction shall be taken to be the median of the dataset.

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Application of Arithmetic mean

In a case where the dataset consists of **less than six comparables**, or the most appropriate method considered for determination of the arm's-length price is profit split method or 'other method', the arm's-length price will be determined based on the arithmetical mean of all the prices/data included in the dataset. Further, where the variation between the arm's length price so determined and price at which the international transaction or SDT has actually been undertaken does not exceed three per cent of the latter, the price at which the international transaction or SDT has actually been undertaken shall be deemed to be the arm's length price, in such cases.

When is the AO empowered to determine the arm's-length price

The AO has been empowered to determine the arm's-length price if based on the material and information available with him, he is of the opinion that¹⁷ :

- the price charged or paid in an international transaction or SDT has not been determined based on the methods prescribed and the arm's-length price as discussed aforesaid; or
- any information and document relating to an international transaction or SDT have not been kept and maintained as prescribed; or
- the information or data used in computation of the arm's-length price is not reliable or correct; or
- the taxpayer has failed to furnish any information or document within the specified time as required

The provisions also stipulate that in case certain profits, which are otherwise tax sheltered, are enhanced by application of Transfer Pricing provisions, no tax exemption would be available on such enhanced profits¹⁸.

However, it would be pertinent to note that based on the instruction no. 3/2016 dated 10 March 2016 issued by the CBDT, though the AO is empowered under section 92C, determination of arm's-length price shall not be carried out at all by the AO in a case where reference is not made to the TPO.

Reference to Transfer Pricing Officer

Section 92CA of the Act provides that if the AO considers necessary or

¹⁷ Section 92C(3) of the Act

¹⁸ Proviso to section 92C(4) of the Act

expedient, he may with the prior approval of the Commissioner refer the computation of arm's-length price to the Transfer Pricing Officer (TPO). As prescribed under instruction no. 3/2016, issued on 10 March 2016, the AO shall henceforth make a mandatory reference to the TPO only under the following circumstances:

- All cases selected for scrutiny on the basis of TP risk parameters either under:
 - Computer assisted scrutiny selection system; or
 - Compulsory manual selection system in accordance with the CBDT's annual instructions
- Cases selected for scrutiny on non-TP risk parameters in the following circumstances:
 - Where the taxpayer has either not filed the Accountant's Report under Section 92E of the Act or has not disclosed an international transaction or SDT or both in the Accountant's Report;
 - Where there has been a TP adjustment of Rs. 10 crore or more in an earlier assessment year and such an adjustment has been upheld by the judicial authorities or is pending in appeal; and
 - Where search and seizure or survey operations have been carried out and findings regarding TP issues in respect of international transactions or SDTs or both have been recorded by the Investigation Wing or the AO.
- Cases involving a TP adjustment in an earlier assessment year that has been fully or partially set-aside by the Tribunal, High Court or Supreme Court on the issue of the said adjustment.

It is clarified that the determination of the arm's-length price should not be carried out at all by the AO in a case where reference is not made to the TPO.

Following the prescribed process, the TPO can determine the arm's-length price and send a copy of his written order to the AO and to the taxpayer. The AO will then compute the taxpayer's income in conformity with such order of the TPO.

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No adjustment to associated enterprise's income

In cases where the total income of a taxpayer is re-computed after determination of the arm's-length price paid to another associated enterprise from which tax has been deducted or was deductible at source, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's-length price in the case of the taxpayer¹⁹.

6.7 Safe Harbour Rules (SHRs)

6.7.1 Safe Harbour

The safe Harbour mechanism was introduced by Finance Act, 2009 under which the Central Board of Direct Taxes (CBDT) was given the authority to frame safe harbour rules. To reduce increasing number of transfer pricing audits and prolonged disputes, CBDT notified the safe harbor rules in September 2013.

Safe Harbour has been defined to mean circumstances in which the income –tax authorities shall accept the transfer price declared by the taxpayer.

International Transactions

In exercise of power conferred under section 92CB, the CBDT, on 18 September 2013, issued the final safe harbor rules (SHRs)²⁰ for the international transactions entered into by the taxpayer with its AEs. Further, the CBDT vide notification 46/2017 dated 7th June, 2017 revised the safe harbor guidelines effective from 1st April, 2017.

Categorisation of services, definition of eligible assessee and eligible international transactions

The definitions of various eligible international transactions, including that of IT, ITES, KPO services and contract R&D services relating to software development and generic pharmaceutical drugs and low value-adding intra-group services have been provided in the SHRs.

Further, according to SHRs an eligible assessee, with insignificant risks shall be determined based on the following principle:

To be eligible to opt for Safe Harbour Rules the foreign principal of the taxpayer should perform economically significant functions, should provide

¹⁹ Proviso to section 92C(4) of the Act

²⁰ Rules 10TA to 10TG

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for capital and funds and economically significant assets including intangibles. Further the control and supervision of the taxpayer's activities must rest with the foreign principal. Most importantly, the conduct rather than the contractual terms between the taxpayer and the foreign principal would be the determining factor of taxpayer's risk profile.

The eligible international transactions and the applicable safe harbour norms are as under:

For Assessment Year 2017-18 and two assessment year immediately following that assessment year²¹ It may be noted that the CBDT issued Notification²² wherein it has notified the year of applicability of the 'Safe Harbour Rules for International Transactions' (SHR) for Assessment Year (AY) 2020-21, as the existing rules were applicable only up to AY 2019-20. The said notification are applicable from 1 April 2020 :

Eligible International Transaction	Safe Harbour ratios
Software development services and information technology enabled services <ul style="list-style-type: none"> • where the aggregate value of such transactions \leq INR 100 crores • where the aggregate value of such transactions $>$ INR 100 crores <u>but does not exceed 200 crores</u> 	Operating profit margin to operating expense <ul style="list-style-type: none"> • \geq 17 per cent • \geq 18 per cent.
Knowledge process outsourcing services: where the aggregate value of such transactions <u>does not exceed INR 200 crores</u> and <ul style="list-style-type: none"> • employee cost/operating cost is \geq 60 percent 	Operating profit margin to operating expense <ul style="list-style-type: none"> • \geq 24 percent • \geq 21 percent • \geq 18 percent

²¹ Refer Rule 10TD

²² Notification No 25 of 2020 dated 20 May 2020

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Eligible International Transaction	Safe Harbour ratios
<ul style="list-style-type: none"> • employee cost/operating cost is \geq 40 percent • employee cost/operating cost is $<$ 40 percent 	
<p>Advanced Intra-group loan where the amount of loan is denominated in India currency (INR): where AEs CRISIL credit rating is</p> <ul style="list-style-type: none"> • AAA to A or its equivalent; • BBB-, BBB or BBB+ or its equivalent; • BB to B or its equivalent; • C to D or its equivalent; • not available and the aggregate amount of loan to all AEs does not exceeds 100 crores rupees as on 31st March of the relevant Previous year 	<p>Interest rate shall not be less than one year marginal cost of funds lending rate of state bank of India as on 1st April of the relevant previous year plus prescribed basis points</p> <ul style="list-style-type: none"> • 175 bps • 325 bps • 475 bps • 625 bps • 425 bps
<p>Advanced Intra-group loan where the amount of loan is denominated in foreign currency: where AEs CRISIL credit rating is</p> <ul style="list-style-type: none"> • AAA to A or its equivalent; • BBB-, BBB or BBB+ or its equivalent; • BB to B or its equivalent; • C to D or its equivalent; • not available and the aggregate amount of loan to all AEs does not exceeds 100 crores rupees as on 31st March of the relevant Previous year 	<p>Interest rate declared in relation to the eligible international transaction is \geq the six-month London Inter-Bank Offer Rate of the relevant foreign currency as on 30th September of the relevant previous year plus the specified basis points:</p> <ul style="list-style-type: none"> • 150 bps • 300 bps • 450 bps • 600 bps • 400 bps

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Eligible Transaction	International	Safe Harbour ratios
Contract research and development services (Contract R&D services), wholly or partly relating to software development and generic pharmaceutical drugs <ul style="list-style-type: none"> • where the aggregate value of such transactions \leq INR 200 crores 		Operating profit margin to operating expense \geq 24 per cent
Receipt of low value-adding intra-group services <ul style="list-style-type: none"> • where the aggregate value of such transactions \leq INR 10 crores 		Cost plus mark-up of not more than 5% Provided that the method of cost pooling, the exclusion of shareholder costs and duplicate costs from the cost pool and the reasonableness of the allocation keys used for allocation of costs to the assessee by the overseas associated enterprise, is certified by an accountant.

Procedural requirements

To exercise their option to be governed by the SHRs, the taxpayer is required to file specified form (Form No 3CEFA) with the AO on or before the due date for furnishing the return of income for –

- the relevant assessment year, in case the option is exercised only for that assessment year; or
- the first of the assessment years, in case the option is exercised for more than one assessment years.

The Form No. 3CEFA requires information on the nature of business or activities of the taxpayer as well as details of the eligible international transactions opted for the SHRs. The return of income needs to be furnished before the date of furnishing of Form 3CEFA.

In case SHRs are opted at once for more than one assessment years, the taxpayer, for each assessment years following the initial assessment year,

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needs to furnish a statement to the AO providing details of eligible transactions, their quantum and details of the profit margins or the rate of interest or commission, before furnishing return of income of that year.

Even where the taxpayer opts to be governed by the SHRs, they will be required to maintain transfer pricing documentation u/s 92D of the Act and file the Accountant's report u/s 92E of the Act on or before the due date of filing of return of Income for each AY under consideration.

Validity for three years

The SHR will be valid for upto a period of 3²³ years. The taxpayer shall, in respect of the assessment year (AY) beginning from AY 2017-18 or years following the initial AY, furnish a statement in the prescribed form (Form No. 3CEFA) to the AO before furnishing return of income of that year, providing details of eligible transactions, their quantum and details of the profit margins or the rate of interest or commission. The SHRs are applicable for AY 2017-18 and two AYs immediately following the initial AY for the prescribed sectors. The option of being governed by SHRs shall continue to remain in force for the period specified by the taxpayer in Form No. 3CEFA or a period of two years whichever is less.

Continued applicability of SHR

The taxpayer can opt-out of the safe harbour regime from the second year onwards, by filing of a declaration to that effect with the AO. Further the option exercised by the taxpayer can be held invalid by the TPO (relating to the eligibility of the taxpayer or of the international transaction or both), if there is change in the facts and circumstances on the basis of which the option exercised by the taxpayer was initially held to be valid. However, such withdrawal cannot be done without providing opportunity of being heard. In this case, the taxpayer has a right to file his objection with the Commissioner.

Timelines prescribed and taxpayers granted right to object against adverse order

The Rules provide for a time bound procedure for determination of the eligibility of the taxpayer and the international transactions for SHR. In case action is not taken by AO/TPO within the following time lines, the option exercised by the taxpayer shall be treated as valid:-

²³ For earlier safe harbour rules, it was five years.

- reference by the AO to the TPO shall be made (for determination of the eligibility of the taxpayer or eligibility of the international transactions or both) within a period of two months from the end of the month in which Form No. 3CEFA is received by him.
- TPO shall pass an order determining the validity of the option exercised by the taxpayer within a period of two months from the end of the month in which reference is received from the AO;

Further, the taxpayer shall have a right to file an objection with the Commissioner against adverse order regarding the eligibility of taxpayer/international transaction. Here again if the Commissioner does not pass an order within a period of two months from the end of the month in which the objection has been received by him from the taxpayer, the option exercised by the taxpayer shall be treated as valid.

Other key considerations

- Safe harbour rules shall not apply if an associated enterprise is located in any country or territory notified under Section 94A of the Act, or in a no tax or low tax country or territory.
- A tax payer opting for SHRs shall not be able to invoke Mutual Agreement Procedure (MAP).

Safe Harbour Rules for Government Owned Electricity Companies and cooperative society engaged in business of milk or milk products²⁴

The government has notified the SHR for eligible SDT of the electricity companies owned by the government vide notification dated 04 February 2015. These Transfer Pricing documentation rules prescribing specific documentation requirements will have to be followed by Government companies engaged in the business of generation, transmission or distribution of electricity and cooperative society engaged in the business of procuring and marketing of milk and milk products.

Widening of scope of SH by Finance Act 2020

Attribution of profit to permanent establishment / business connection has always remained a contentious issue. In order to enable taxpayers to obtain

²⁴ Rule 10THA to 10THC of the Rules

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upfront certainty on this issue, the Finance Act 2020 has made amendments in section 92CB and has enabled the CBDT to notify SH for profit attribution to PE / business connection.

6.8 Advance Pricing Agreement

The Finance Act 2012 introduced the Advance Pricing Agreement (APA) Program to be effective from 1 July 2012. The CBDT notified the APA scheme vide notification no. 36 of 2012 dated 30 August 2012.

APA is an agreement between the tax authorities and the taxpayer that determines in advance the most appropriate transfer pricing methodology or the arm's length price for covered intercompany international transactions.

Salient Features of the APA Rules

The Rules²⁵ provide as under

- Any person who has undertaken or is contemplating to undertake an international transaction shall be eligible to enter into an APA.
- Unilateral, bilateral and multilateral APAs may be entered into. Application for an APA shall be made in Form No. 3CED to the DGIT in case of unilateral APA (or the Competent Authority in the case of bilateral or multilateral APA).
- APA shall not be binding on the CBDT or the taxpayer if there is a change in any of the critical assumptions - "Critical assumptions" means the factors and assumptions that are so critical and significant that neither party entering into an agreement will continue to be bound by the agreement, if any of the factors or assumptions is changed.

Procedure

- Pre-filing Consultation available - Every person proposing to enter into an APA may or may not make an application in writing, requesting for a pre-filing consultation in Form No. 3CEC to the DGIT. The pre-filing consultation is therefore optional and shall, among other things:
 - determine the scope of the agreement;
 - identify transfer pricing issues;

²⁵ Section 92CC and 92CD read with Rule 10F to 10T

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- determine the suitability of international transaction for the agreement;
- discuss broad terms of the agreement.

The pre-filing consultation shall not be binding on the board or the person. The fees payable shall be in accordance with following table based on the amount of international transaction entered into or proposed to be undertaken in respect of which the agreement is proposed:

Amount of international transaction entered into or proposed to be undertaken	Fee (INR)
Amount not exceeding 100 crores	10 Lacs
Amount exceeding 100 crores but not exceeding 200 crores	15 Lacs
Amount exceeding 200 crores	20 Lacs

- Application for an APA shall be made in Form No. 3CED to the DGIT in case of unilateral APA (or the Competent Authority in the case of bilateral or multilateral APA). Following are some of the important details required to be furnished by the applicant taxpayers as stated in Form No. 3CED:
 - Corporate background of the applicant taxpayer and its AEs;
 - Transaction flows of the multinational enterprise (volumes, directions and amounts) that may have an impact on the pricing of the covered transactions;
 - Detailed functional analysis of the applicant taxpayer and all relevant entities with respect to the covered transactions;
 - Business strategies, including current and future Budget statements, projections and business plans for future period covered by proposed APA, general business and industry trends, future direction/business strategy including R&D, production, and marketing;
 - Copies of all relevant intercompany agreements (pricing, cost sharing, licensing, distributorship etc.);
 - Detailed analysis of industry and markets for all countries involved;
 - Discussion of relevant legal considerations and requirements;

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- Discussion of transfer pricing methodologies, policies, and practices used by the applicant taxpayer and AEs for the covered transactions during the past three years, or business cycle as appropriate;
 - Discussion of relevant rulings, APAs and other similar arrangements entered into with foreign tax administrations, for transfer pricing or other valuation bases, or other taxation matters entered into by the applicant (or its AEs) and Indian or foreign tax administrations;
 - Discussion of relevant Indian income tax audit, appeals, judicial and competent authority history;
 - Discussion of un-assessed taxation years (Indian and foreign) and related outstanding tax, legal, and other pertinent issues; etc.
- **Timeline for making an application** - In case an application is made for an international transaction of a continuing nature then it shall be made before the first day of the previous year relevant to the first assessment year for which the application is made. In any other case, before entering into the international transaction under consideration.
 - **Withdrawal of APA Application** - The applicant taxpayer may withdraw the application of APA in Form No. 3CEE at any time before the finalization of the terms of the APA. However, no refund of fees shall be granted in such event.
 - During the APA process, meetings with and site visits to the applicant taxpayer's premises may be permitted.
 - The APA shall be entered into by the CBDT with the applicant taxpayer, after its approval by the Central Government.

Rollback of APA

The Finance (No.2) Act, 2014 introduced the rollback provisions under the APA program. The roll back provisions were made applicable to the APAs signed or applied post 1 October 2014. The rules²⁶ were notified on 14 March 2015 setting out the applicability and the requirement for applying rollback.

²⁶ Section 92CC and 92CD read with Rule 10MA & Rule 10RA

The Rollback rules provide as under:

- The international transaction proposed to be covered under the rollback is to be the same as covered under the main APA.
- To be eligible for the applicability of the rollback provisions, the applicant should have filed Return of Income and Form No. 3CEB (Accountants Report) on or before the statutory due date.
- The rollback provisions shall be applied for all the rollback years in which the relevant international transaction has been undertaken. It has been clarified that the applicant taxpayer has to either apply for a rollback for all the four years or not apply at all and does not have the option to choose any specific year/s for rollback. However, if the covered international transaction(s) did not exist or there is some other disqualification due to which rollback cannot be claimed, then the applicant can apply for rollback for less than four years.
- The manner in which Arm's length price has been determined in relation to an international transaction shall be consistent for all the years covered under the APA including the rollback years.
- The rollback provision will not be applicable for a particular year where the Income Tax Appellate Tribunal has passed an order disposing off the appeal prior to the date of signing of the APA.
- In case the application of the rollback provisions would result in reduction of the income offered to tax or increasing the loss as declared in the Return of Income for a particular year, the rollback provision will not be applicable for that year.
- The application for rollback has to be made (Form No. 3CEDA) along with the main APA application (Form No. 3CED).
- **Filing of Modified Return of Income** – The applicant taxpayer shall be required to file the modified Return of Income in respect of rollback years along-with the modified Return of Income of first year of the APA, within three months from the end of the month in which the APA is signed.
- **Annual Compliance Report** - The taxpayer, who has entered into an APA, would be required to file an annual compliance report to the DGIT for each year covered in the APA, in Form No. 3CEF, within 30

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days of the due date of filing the income-tax return for that year, or within 90 days of entering into the APA, whichever is later.

- **Annual Compliance Audit** - The TPO shall carry out a compliance audit for each year covered in the agreement. Time limit for completion of the same is 6 months from the end of the month in which annual compliance report is filed. Regular audit not to be undertaken for transactions covered by the APA.
- **Revision of APAs** - Possible in case of:
 - Change in critical assumptions;
 - Change in law;
 - Request from competent authority of other country in case of bilateral and multilateral agreements.
- **Cancellation of APA** - The Board may cancel the APA for:
 - Failure of the taxpayer to comply with the terms of the agreement;
 - Failure to file the annual compliance report in time;
 - Annual compliance report filed contains material errors;
 - The taxpayer does not agree for revision of the APA.

If the applicant taxpayer does not carry out any actions prescribed under rollback rules for any of the rollback years, the entire APA shall be cancelled.

- Renewal of the agreement is permissible, however no pre-filing consultation required.
- For bilateral and multilateral APAs, the AE would be required to initiate the APA process in the other country. The Indian Competent Authority shall consult and ascertain willingness of the Competent Authority in the other country for initiation of negotiations. The applicant taxpayer shall not be entitled to be part of discussion between the Competent Authority in India and the Competent Authority in the other country or countries.
- The applicant taxpayer needs to communicate acceptance or otherwise to the APA agreed between Competent Authorities within 30 days.

Widening of scope of APA by Finance Act 2020

Attribution of profit to permanent establishment / business connection has always remained a contentious issue and there was an ambiguity on whether a taxpayer could seek an APA for determining attribution of profits to a PE. In order to enable taxpayers to obtain upfront certainty on this issue, the Finance Act 2020 has brought in amendment to section 92CC of the Act, to allow the taxpayer to apply for APA with respect to attribution of profits to PE / business connection in India.

6.9 Secondary Adjustment

The Finance Act 2017, introduced new section 92CE under the Act giving statutory validity to the concept of secondary adjustment. The Act encompasses two types of adjustments in case of transfer pricing namely primary adjustment and secondary adjustment.

- Primary Adjustment to a transfer price means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the Assessee.
- Secondary Adjustment means an adjustment in the books of account of the Assessee and its Associated Enterprise to reflect that the actual allocation of profit between the Assessee and its Associated Enterprise are consistent with the transfer price determined as a result of the primary adjustment, thereby removing the imbalance between cash account and actual profit of the Assessee.

As per provisions contained in section 92CE, the secondary adjustment is required where a primary adjustment to the transfer price :

- has been made suo motu by the assessee in his return of income;
- made by the Assessing Officer has been accepted by the assessee;
- is determined by an advance pricing agreement entered into by the assessee under section 92CC
- is made as per the safe harbor rules framed under section 92CB
- is arising as a result of resolution of an assessment by way of the mutual agreement procedure

Secondary Adjustment would apply only when the primary adjustment results in to an increase in total income or reduction in loss of more than 1 crore

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rupees in respect of an assessment year commencing after 1st day of April, 2016.

Excess money available with its AE as a result of primary adjustment, if not repatriated to India within 90 days, is to be treated as an interest bearing advance and interest on excess money not repatriated in India shall be computed..

The CBDT, vide Notification no.52/2017 dated 15 June 2017 prescribed the rate and manner of computing interest. The imputed per annum interest income on excess money which is not repatriated within the time limit as per sub-section (1) of section 92CE of the Act shall be computed:

- For an international transaction denominated in INR – At one year marginal cost of fund lending rate of State Bank of India as on 1st of April of the relevant previous year plus 325 basis points
- For an international transaction denominated in foreign currency – At six month LIBOR as on 30th September of the relevant previous year plus 300 basis points.

The Finance Act 2019, in order to address the concerns and make the secondary adjustment regime more effective has provided the following:

- excess money or part thereof may be repatriated from any of the AEs of the assessee which is not a resident in India.
- In a case where the excess money or part thereof has not been repatriated in time, the assessee will have the option to pay additional income-tax at the rate of eighteen percent on such excess money or part thereof
- The tax so paid shall be the final payment of tax and no credit shall be allowed in respect of the amount of tax so paid;
- The deduction in respect of the amount on which such tax has been paid, shall not be allowed under any other provisions of the act; and
- If the assessee pays the additional income-tax, he will not be required to make secondary adjustment or compute interest from date of payment of such tax.
- The above amendments are applicable from assessment year 2018-19 onwards

6.10 Three-tier Transfer Pricing Documentation

6.10.1 Local file Documentation

The Income Tax Rules prescribe detailed Transfer Pricing Documentation to be maintained by the taxpayer for demonstrating compliance with the arm's length standard. Every associated enterprise entering into an international transaction or SDT must keep and maintain prescribed information/documents, which must be provided in the event of a request by the AO/TPO.

The documentation requirements are two-fold, viz., primary and support. While the taxpayer must maintain the primary documentation, the support documentation requirements are optional and may be maintained by the taxpayer.

Primary documentation

Every person who has entered into an international transaction with an associated enterprise would be required to maintain the following information and contemporaneous documents²⁷

- Description of the ownership structure of the taxpayer with details of shares or other ownership interest held therein by other enterprises;
- A profile of the multinational group of which the taxpayer is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions or SDTs have been entered into by the taxpayer, and ownership linkages among them;
- A broad description of the business of the taxpayer and the industry in which the taxpayer operates, and of the business of the associated enterprises with whom the taxpayer has transacted;
- Nature and terms (including prices) of international transactions or SDTs entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;
- Description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated enterprises involved in the international transaction or SDT;

²⁷ Section 92D of the Act r.w. Rule 10D of the Rules

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- Record of economic and market analyses, forecasts, budgets or other financial estimates prepared by the taxpayer for the business as a whole and for each division or product separately, which may have a bearing on the international transactions or SDTs entered into by taxpayer;
- Record of uncontrolled transactions taken into account for analysing their comparability with the international transactions or SDTs entered into including a record of nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions or SDTs;
- A record of analysis performed to evaluate the comparability of uncontrolled transactions with the relevant international transaction or SDT;
- Description of methods considered for determining the arm's-length price in relation to each international transaction or SDT or class of transaction, the method selected as the most appropriate method along with reasons and explanations as to why such method was so selected, and how such method was applied in each case;
- A record of the actual working carried out for determining the arm's-length price including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for the differences between the international transaction or SDT and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;
- The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's-length price;
- Details of the adjustments, if any, made to transfer prices to align them with arm's-length prices determined under the Regulations and consequent adjustments made to total income for tax purposes; and
- Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's-length price.

Documentation not to be maintained in certain cases

- The prescribed documents need not be maintained in cases where the aggregate book value of international transactions entered into by the

taxpayer does not exceed Rs. 10 million²⁸. However, in such cases, the taxpayer would need to substantiate, on the basis of material available with him, that income arising from international transactions or SDT entered into by him has been computed in accordance with the arm's-length principle.

Support documentation

The Regulations also prescribe that the primary documentation referred above can be supported by the following documents²⁹:

- Official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;
- Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
- Price publications including stock exchange and commodity market quotations;
- Published accounts and financial statements relating to the business affairs of the associated enterprises;
- Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions or SDTs;
- Letters and other correspondences documenting any terms negotiated between the taxpayer and its associated enterprises; and
- Documents normally issued in connection with various transactions under the accounting practices followed.

Relaxation of requirement to maintain fresh documentation

It is prescribed that in cases where an international transaction or SDT continues to have effect over more than one financial year, fresh documentation need not be maintained separately in respect of each financial year, unless there is any significant change in the nature or terms of the international transaction or SDT, in the assumptions made, or in any

²⁸ Rule 10D(2) of the Rules

²⁹ Rule 10D(3) of the Rules

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other factor which could influence the transfer price, and in case of such significant change, fresh documentation shall be maintained bringing out the impact of the change on the pricing of the international transaction or SDT³⁰.

6.10.2 Master file

In line with the BEPS Action Plan 13, the Finance Act 2016 introduced new provisions i.e. section 92D(4) read with section 286 in relation to master file and CbCR requirements applicable from FY 2016-17.

As per the proviso to section 92D(1) and sub-section (4) of section 92D, every constituent entity of international group is required to keep and maintain such information and document in respect of an international group as may be prescribed.

Every person, being a constituent entity of international group having consolidated group revenue exceeding five hundred crores for the accounting year and aggregate value of international transactions:

- during the accounting year, as per books of account, exceeds fifty crore rupees, or
- in respect of purchase, sale, transfer, lease or use of intangible property during the accounting year, as per the books of accounts, exceed ten crore rupees.

is required to keep and maintain following information and documents of international transaction namely-

- the nature of the business or businesses;
- the important drivers of profits of such business or businesses;
- a description of the supply chain for the five largest products or services of the international group in terms of revenue and any other products including services amounting to more than five per cent of consolidated group revenue;
- a list and brief description of important service arrangements made among members of the international group, other than those for research and development services;
- a description of the capabilities of the main service providers within the international group;

³⁰ Proviso to rule 10D(4) of the Rules

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- details about the transfer pricing policies for allocating service costs and determining prices to be paid for intra-group services;
- a list and description of the major geographical markets for the products and services offered by the international group;
- a description of the functions performed, assets employed and risks assumed by the constituent entities of the international group that contribute at least ten per cent of the revenues or assets or profits of such group; and
- a description of the important business restructuring transactions, acquisitions and divestments;

The information mentioned above shall be furnished to the Joint Commissioner of Income tax in Form No. 3CEAA, on or before the due date of furnishing the return of income.

Further, Part A of above Form 3CEAA, is required to be furnished by the constituent entity, even if the threshold provided above are not met.

Further, in case there are more than one constituent entity in India, the report may be furnished by the constituent entity designated by the international group and the same has been intimated by the designated constituent entity to the Joint Commissioner of Income Tax in Form 3CEAB atleast 30 days before the due date of filing the report.

The rate of exchange for the calculation of the value in rupees of the consolidated group revenue in foreign currency shall be the telegraphic transfer buying rate of such currency on the last day of the accounting year.

6.10.3 Country-by-country reporting (CbCR)

A new section (Section 286 of the Act) has been introduced for Country-by-Country (CbC) reporting. These provisions require the Indian Parent entity of an international multinational group or any other designated group entity in India (referred to as alternate reporting entity) to file a CbC report in Form 3CEAD within a period of 12 months from the end of the said reporting accounting year. The threshold for filing the CbC report has been maintained at INR 5500 crore.

The CbC report will be required to furnish the following details:

- Aggregate information in respect of the amount of revenue, profit or loss before income-tax, income-tax paid and accrued, stated capital,

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accumulated earnings, number of employees and tangible assets not being cash or cash equivalents, with regard to each country in which the group operates;

- Details of each constituent entity of the group including the country in which such constituent entity is incorporated or organised or established and the country where it is resident;
- Nature and details of the main business activity or activities of each constituent entity.
- Any other information as may be prescribed

The key highlights of the CbC reporting provisions are as follows:

- CbC report will have to be furnished by the local constituent Indian entity if,
 - the parent entity is resident of a country with which India does not have an agreement providing for exchange of information under the CbC report; or
 - there has been a systemic failure of that country.
- Where there are more than one constituent entities of the international group, resident in India, the CbC report shall be furnished by any one constituent entity, if the international group has designated such entity to furnish the CbC report (information to be conveyed in writing to the prescribed Indian tax authorities in Form 3CEAE).
- If any other alternate reporting entity of the international group has furnished the CbC report with the tax authority of their country, there will be no need for the local constituent entity to furnish the same again locally, if the following conditions are satisfied:
 - the CbC report is required to be furnished under the local law of that country;
 - that country has entered into an agreement with India providing for exchange of the CbC report in respect of the international group;
 - Indian income-tax authority has not conveyed any systemic failure in respect of the said country to any constituent entity resident in India;

- the said country or territory has been informed in writing by the constituent entity that it is the alternate reporting entity on behalf of the international group.

For these purpose, the following terms have been defined in section 286:

'Systemic failure' with respect to a country means that the country has an agreement with India providing for exchange of CbC report, but:

- a) in violation of the said agreement, it has suspended automatic exchange; or
- b) has persistently failed to automatically provide to India the report in its possession in respect of any international group having a constituent entity resident in India.

'constituent entity' means:

- a) any separate entity of an international group that is included in the consolidated financial statement of the said group for financial reporting purposes, or is included for the said purpose, if the equity share of any entity of the international group were to be listed on a stock exchange;
- b) any such entity that is excluded from the consolidated financial statement of the international group solely on the basis of size or materiality; or
- c) any permanent establishment of any separate business entity of the international group included in (a) or (b) above, if such business unit prepares a separate financial statement

'accounting year' means,—

- a) a previous year, in a case where the parent entity is resident in India; or
- b) an annual accounting period, with respect to which the parent entity of the international group prepares its financial statements under any law for the time being in force or the applicable accounting standards of the country or territory of which such entity is resident, in any other case;

'international group' means any group that includes:

- a) two or more enterprises which are resident of different countries; or

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- b) an enterprise, being a resident of one country, which carries on any business through a permanent establishment in other countries.

6.10.4 Period of maintenance of documentation

The specified information and documents are required to be kept and maintained for a period of eight years from the end of the relevant assessment year.

6.11 Other provisions

Accountant's report

Every person entering into an international transaction or SDT³¹ during a previous year should furnish a prescribed report in Form No. 3CEB obtained from an accountant by the specified date.

As per amendment made by Finance Act 2020, the due date specified for filing Form 3CEB is advanced by one month to 31 October of the relevant assessment year as against 30 November.

6.12 Penalties

The Transfer Pricing provisions stipulate stringent penalties for non-compliance as mentioned below:

- Failure to keep and maintain prescribed documentation or to report transaction or incorrect maintenance / submission of documents could attract penalty at the rate of 2 percent of the value of each international transaction or SDT – Section 271AA of the Act.
- Failure to furnish master file as required under section 92D(4), the tax authorities could attract a penalty of five hundred thousand rupees – Section 271AA of the Act.
- Failure to furnish documentation required by the tax authorities could attract a penalty at the rate of 2 percent of the value of each international transaction or SDT – Section 271G of the Act.
- Failure to furnish the prescribed report of the accountant can attract penalty of one hundred thousand rupees – Section 271BA of the Act.
- Furnishing incorrect information in reports or certificates furnished under any provisions of the act or the rules made thereunder would

³¹ If value of SDT exceeds INR 20 crores during the previous year

attract penalty of ten thousand rupees per certificate / report – Section 271J of the Act

- Failure to adherence to the compliance under section 286(2), the tax authorities could attract the following penalties – Section 271GB of the Act;
 - Failure to furnish the report within due date, the tax authority could levy penalty of five thousands rupees every day up to the failure does not exceeds one month or fifteen thousand rupees for every day for which the failure continues beyond the period of one month- Section 271GB (1) of the Act;
 - Failure to furnish the information and documents to tax authority under section 286(6) within the time period allowed in notice, the tax authority could levy penalty of five thousands rupees every day - Section 271GB (2) of the Act;
 - If the failure continues after the penalty order is served under section 271GB (1) or 271GB (2), the tax authority could levy penalty of fifty thousand rupees every day during which such failure continues - Section 271GB (3) of the Act;
 - Furnishing inaccurate information and document in the report in nature of required under section 286(2) or information and document furnished under section 286(6), the tax authority could levy penalty of five lakh rupees- Section 271GB (4) of the Act;

In the above cases, if the taxpayer could prove to the satisfaction of the tax authorities that he had reasonable cause for not complying with the relevant statutory requirements, no penalty would be levied.

The Finance Act, 2016 inserted new section 270A for under-reporting and mis-reporting of income which provides that pursuant to a Transfer Pricing adjustment, the following specific penalty provisions shall be leviable, in situations wherein the taxpayer has failed to maintain appropriate documentation or failed to disclose international transaction:

- Penalty at 50 per cent of the tax payable on under-reported transaction
- Penalty at 200 per cent of the tax payable on misreporting of transaction

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The under-reported income shall not include the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the TPO, where the taxpayer had maintained information and documents as prescribed under section 92D, declared the international transaction and disclosed all the material facts relating to the transaction.

6.13 Controversial issues/ Developments in Transfer Pricing

6.13.1 Introduction

Since its introduction in 2001, the Indian Transfer Pricing legislation has evolved and is en-route to align with the global best practices. The government is keen to reduce litigation on the transfer pricing front and efforts are underway in this direction. However, from the routine issues (like comparables, multiple-year analysis etc.) the Transfer Pricing landscape is now beset with a myriad of controversial issues (like marketing intangibles, intra-group services etc.) and significant litigation. The following paragraphs discuss some of the key issues in Transfer Pricing:

6.13.2 Risk Adjustments

Risk adjustments have been the biggest issue for the captive industry in India. India has developed over the last decade as a hub for captives with many MNEs shifting their back office operations to India. Many of these captives operate on cost plus model and are insulated from market and other risks that entrepreneurial enterprises face. Hence, the taxpayers & the Transfer Pricing professionals have been contending before the tax authorities that the arm's length margins, determined based on the profitability of entrepreneurial enterprises, must be adjusted to account for differences in the risk between the comparables and the tested party.

While the TPOs have not been allowing risk adjustments in most of the cases on the ground that any risk adjustment to be allowed gets offset by the single customer risk assumed by the captive service provider, the Tax Tribunals have consistently upheld that risk adjustments must be allowed. However, the manner in which the risk adjustments can be quantified remains a challenge as ITAT rulings are both in favour and against the taxpayers.

6.13.3 Interest free loans to wholly owned subsidiaries

Inter company loans provided are the most common source of intra group funding. Typically, the group treasury is responsible for raising funds from

capital markets and then disbursing them to subsidiaries in the form of loans. Or the holding company usually provides finance to its wholly owned subsidiary at a nominal or no interest.

This has led to the TPOs to treat such loans as a capital contribution and make transfer pricing adjustments on account of interest payments, where the same is being treated as an international transaction.

6.13.4 Marketing Intangible

Many Indian subsidiaries of foreign MNEs incur AMP (advertisement, marketing and sales promotion) expenses in India. The Tax Authorities are taking a view that by incurring such expenses, Indian subsidiaries are promoting the brand of the foreign company and thereby developing a marketing intangible for the foreign company for which the Indian company must be compensated. This can be either by way of reimbursement of marketing expenses or probably by receiving a cost plus mark-up on such part of AMP expenses which is in excess of that incurred by the comparables i.e. in excess of 'bright line' exposure. .

There have been two landmark judgments by the Delhi High Court in the case of Sony Ericsson Mobile Communication India Pvt. Ltd (ITA 16/ 2014) and Maruti Suzuki India Limited (ITA 110/2014) wherein the Court laid down certain important principles but did not lay down the methodologies / approaches that taxpayers can adopt for determining arm's-length price. Currently, the issue is pending before the Apex court.

6.13.5 Management Services/ Intra-group service charges

Management services/ intra-group service charges are another issue that has been the bane of arguments between the taxpayer and the tax authorities. The tax authorities are circumspect about these payments and treat them as instruments to shift profits from India. The tax authorities argue that unless the taxpayer can provide credible evidence that the management services received from foreign affiliates have actually benefited the Indian company, the arm's length value for the management services may be regarded to be NIL and hence the amount paid by the taxpayer for management recharges must be added to the taxable income.

For demonstrating that the management services have actually benefited the taxpayer, the following tests may be satisfied:

- Need Test – Demonstrating that the taxpayer required these services

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- Benefit Test – Demonstrating that the taxpayer has derived benefit from these services
- Evidence Test – Providing evidence that the services have been rendered

This issue underlines the need to maintain robust Documentation to demonstrate that the management services comply with the arm's length standard.

However, reference can be drawn from the OECD guidelines for TP for the arm's length price related to low value added service has as explained in above paras. Also, the arm's length price for the low value added service has been indicated under the safe harbor rules subject to the nature and quantum of eligible international transaction.

6.13.6 Profit attribution to Permanent establishment

The Central Board of Direct Tax ("the CBDT/the Board") came up with a draft report dated 18th April 2019 on approach for profit attribution to PE and invited comments for public consultation. The cause is to bring clarity and removal of ambiguity hovering around the profit attribution to PE. The Board commented that demand is a key factor for generating business profit which as per the Board, has been ignored by the OECD Model tax convention post 2010 amendment. The Board is contemplating to set-up a new formulary approach for allocation of profit to PE by considering the demand factor. The CBDT is disregarding the approach of profit attribution based on Functions, Assets and Risk ("FAR") analysis as it emphasize the supply side and overlooks the demand factor. In its support, the Board has referred India's reservation for amendment brought on Article 7 of model tax convention by OECD in 2010 for allocating the profit to PE based on FAR analysis. Further, the CBDT also highlighted experts view, international practices, judicial pronouncements and UN Model tax convention in advocating the formulary approach. The proposed approach has considered three³² factors i.e. sale, wages and asset with equal weight for allocating the profit to PE. The wages and asset represents supply side and sale represents the demand side.

³² There shall be four factor, in case PE comes to existence due to significant economic presence in India ("SEP")

6.13.7 Documentation requirements

The Indian Transfer pricing regulation provides a detailed list of the documentation and information to be kept and maintained by the taxpayer. As compared to international practices (e.g. OECD guidelines on Transfer Pricing), the requirement under the Indian legislation is very wide and complex.

(a) Threshold limit of Rs 1crore³³

Every person who has entered into an international transaction with an associated enterprise is required to maintain certain primary information and documentation. Such primary documentation need not be maintained in cases where the aggregate book value of international transactions entered into by the taxpayer does not exceed Rs. 1 crore. Notably this appears to conform with the OECD recommendation that the documentation obligations on the taxpayer should be balanced by the costs and administrative burdens and should not be disproportionate to the circumstances. However, the threshold limit of Rs. 1 crore is too small and needs to be revised upwards to around Rs 5 crores. Though the taxpayer is not required to maintain the detail documentation being the value of international transaction is less than the threshold limit of Rs. 1 crore, however, the burden of proof shall be on taxpayer to prove that international transaction is at arm's length price.

(b) Documents/information relating to transactions not entered into by the taxpayer itself

During the Transfer Pricing assessment, the tax authorities in certain cases have asked the taxpayer to provide documents / information about similar transactions which the overseas group entity (associated enterprise) has entered into with other entities within the same group. For example, information (rates and other terms and conditions) regarding supply of similar goods within the group is asked for by the tax authorities. In an era where each entity within the group is an independent 'profit centre', the overseas group entity may not be willing to share the details of its similar transactions with other group entities. It may be pertinent to note that there is no statutory obligation on the Indian entity to maintain such information regarding dealings entered into by the concerned associated enterprise with other overseas related entities. However, the tax authorities do ask for such

³³ Threshold limit for CBCR and Master file is already discussed in preceding paras.

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information and the taxpayers would be well advised to state upfront that it is not possible to obtain this information.

(c) Other issues

The stringent penalty which can be imposed for non-maintenance of documentation may put some taxpayers in a 'tight spot' in certain situations where there is no clarity whether documentation is required to be maintained. For example, in case the tax authorities assume a 'PE of a non-resident in India, whether the non-resident needs to maintain documentation considering the fact that constitution of the PE is itself a subject matter of litigation? Another example is a situation where a transaction has been entered with an unrelated enterprise which later became an associated enterprise during the year.

6.13.8 Application of prescribed method for computation of arm's length price

The arm's-length price in relation to an international transaction is to be determined using the most appropriate method out of the specified methods having regard to the nature or class of transactions or class of associated persons or functions performed by such persons or such other relevant factors as have been prescribed. Currently, six methods have been specified - Comparable Uncontrolled Price Method ['CUP'], Resale Price Method ['RPM'], Cost Plus Method [CPM], Profit Split Method ['PSM'], Transactional Net Margin Method ['TNMM'] and Other Method.

(a) Application of most appropriate method & selection of comparables.

While the Rules provide reference to many factors which need to be considered for establishing comparability and for selection of most appropriate method, the fact remains that finding comparables which are substantially similar to the tested transaction remains a challenge for Transfer Pricing professionals owing to inherent limitations of the databases and lack of publicly available data on transactions which are unquestionably comparable to the tested transaction.

Hence, there is continuous dispute between the tax authorities and the taxpayer as to what constitute the "most appropriate method" and the "arm's length price" in a particular situation.

Even the OECD Transfer Pricing Guidelines recognise this fact and observe that transfer pricing is not an exact science but requires the exercise of

judgment on the part of both the tax administration and taxpayer. Hence, where the taxpayer is able to demonstrate that he has made reasonable effort to satisfy arm's length standard by maintaining adequate Transfer Pricing Documentation, it may not be appropriate for tax authorities to penalise the taxpayer merely because they differ in judgement regarding the comparables/ method selected by him.

In the case of Softbrands India P Ltd³⁴, the hon'ble High Court has observed that matter concerning selection of comparable including application of filters are only fact based and does not involve any question of law. Further, it has also pointed out that Tribunal is the final fact finding body for Arm's Length Price determination and therefore the matter should remain final at the hands of tribunal. In view of this the Hon'ble High Court concluded that the court is unable to call such findings of the Tribunal perverse in any manner so as to require interference under Section 260A.

(b) No mark-up charge in certain cases

The current legislation does not clarify that no mark-up may be charged in certain situations which are highlighted in the OECD Transfer Pricing Guidelines as under:

- where a service is provided by a third party, and the related party adds no significant value, or assumes no major risks with respect to the third party services, e.g., where related party is merely an intermediary and the functions are performed solely by the unrelated party.
- where the market value of the intra-group service is not greater than the costs incurred by the service provider in rendering that service (especially where the service provided is not part of the main business activity of the service provider, but is offered incidentally as a benefit to the related party group)
- where a cost-benefit analysis determines that the additional revenue that would be collected if a mark-up were charged does not justify the costs and administrative burden of determining the arm's-length price.

6.13.9 Implementation of Ind-AS

The Ministry of Corporate Affairs had come up with new set of accounting standard i.e. Indian Accounting standard ("Ind-AS") vide notification dated

³⁴ [TS-475-HC-2018(KAR)-TP]

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16th February, 2015 for preparation of financial statements on or after 1s April 2016. However, the applicability of Ind-AS was subject to net worth of the company and listing status. There are significant changes in the way income and expenses are recognized and shown under Ind AS and previous Accounting Standard (“AS”). For instance, while Ind AS relies on fair value of assets and liabilities and has a thrust on substance of contracts more than their legal forms. On the other hand, AS relies on the principle of prudence and historical cost of assets instead of their fair market valuation. This results in differences in the characterization of financial instruments as well as in revenue recognition. Under Ind-AS, the financial figures of the previous year shall be restated for the purpose of comparability of the financial statement with current year figures. Since the financial statement is the starting point for computation of taxable income and benchmarking of price of international transaction/SDT under the Act and hence, it has an impact on benchmarking of price with comparable data available in publically database. Followings are the few key points which needs to be kept in mind while conducting benchmarking:

- Disclosure requirement for related party transaction under Ind-AS has been changed, hence, there shall be instance where one entity may not be reported as related party in financial statement, however the same can become AE under the Act or *vice-versa*;
- To identify the comparable adopting different standard for financial reporting and make the appropriate adjustment in financial data for comparability purpose;
- To identify the impact of applicability of Ind-AS on multiple year data and range concept;
- Significant practical challenges in undertaking comparability analysis.

6.13.10 Dispute Resolution Mechanism

The DRP mechanism was introduced by Finance Act 2009 to provide alternate dispute resolution mechanism in respect of cases involving Transfer Pricing adjustments or international tax issues. The mechanism has the following apparent advantages over the CIT(A) route:

- The tax demand is kept in abeyance till the matter is pending before the DRP;

- The DRP is a collegium of three commissioners who are required to decide on majority, instead of a single commissioner (Appeal) reviewing the matter;
- Unlike the CIT(A) process, the DRP mechanism is a time bound process with the Dispute Resolution Panel mandatorily required to issue directions within 9 months from the end of the month in which the draft order by the AO is forwarded to the eligible taxpayer;
- The Taxpayer can directly appeal to the Tribunal against the AO's order; and
- The Tax Department cannot appeal against the DRP's directions.

Based on the last statistics available, large number of cases were filed before the DRP which had put a tremendous strain on the 9 month timeline. Thus, the Panel ended up providing very limited opportunity to the taxpayer to explain their position. Further, in substantial cases, the Panel did not deal with the legal issues like the use of multiple year data, risk adjustments for captives, etc., in the end-result, in majority of the cases; the DRP did not provide any relief to the taxpayer.

Amendment by Finance Act 2020

Previously, objections before DRP could be filed by the eligible taxpayer i.e. foreign company or a taxpayer in whose case a transfer pricing adjustment is made. Further, objections can be filed only if the AO proposes to make any variation in the income or loss returned which is prejudicial to the interest of taxpayer.

Finance Act 2020 has amended section 144C of the Act to allow all non-resident (not being a company) to file the objections before DRP whether or not there is an adjustment on account of transfer pricing. Further, the Finance Act has also omitted the words "in the income or loss returned" from subsection (1) to section 144C. Therefore, objections can be filed in every case where there is any variation prejudicial to the taxpayer.

6.13.11 Customs law v. Transfer pricing legislation

Similar to the Transfer Pricing Regulations, the Customs regulations also focus on the value of transactions between associated enterprises to ensure that there is no tax base erosion. This raises a fundamental question whether value determined under the transfer pricing legislation may be used for the

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Customs law or vice versa. In fact, the Customs Department had also issued *Circular 20/2007 dated May 8, 2007* which had laid out the mechanism for coordination between the customs and Tax authorities. However, competing motivation factors and a conflict of interest between the two laws would present practical problems in applying values derived under either legislation to the other. In the case of *M/s Panasonic India Pvt Ltd Vs. Income Tax Officer [2010-TII-47-ITAT-DEL-TP]*, the Delhi Tribunal rejected the taxpayer's contention for relying upon the valuation done by the Special Valuation Branch (SVB) of the Customs Department to justify arm's length character under the Act by observing that where specific rules of law exist in the statute on a particular subject, they would hold the field. Thus, the taxpayers have to walk the tight-rope of fixing the prices of products imported from associated enterprises in such a manner that is neither too high from Transfer Pricing perspective nor too low from Customs perspective.

6.14 Conclusion

The Indian Transfer Pricing provisions are exhaustive in many respects and generally in line with international norms prescribing methodologies and documentation requirements. However, matters such as arm's length test for intangibles, intra-group services and cost-sharing arrangements are not addressed in entirety. The penalties provided for non-compliance are also severe in comparison to international practice.

With the introduction of Advance Pricing Agreement program, reconstitution of DRP and selection of cases for transfer pricing scrutiny proceedings from the erstwhile value-based to risk based approach, it is expected that the Government is keen to move towards the non-adversarial tax regime.

Further, with the adoption of three-tier TP documentation as per BEPS Action Plan 13, India has indicated its intention to align its transfer pricing legislation to global best practices on a real time basis. What is needed is a suitable refinement of the current law, which would enable pragmatic application of the provisions by both the taxpayer and the tax authorities. Simultaneously, intensive training and guidance is the need of the hour, to equip the administrators with the necessary knowledge to handle complex cases. On the part of the authorities, it may be noted that while Transfer Pricing legislation is necessary to get our share of revenue from international transactions, its administration should be fairly and sensitively handled.

ADVANCE RULINGS — LAW AND PROCEDURE

7.1 Introduction

The scheme of advance rulings was introduced from 1st June, 1993 in the Income-tax Act (Chapter XIX-B) to benefit non-residents in obtaining a ruling in advance from the Authority for Advance Rulings (AAR) so that they are not saddled with problems of uncertainty with regard to the taxability of income arising out of the activities or transactions undertaken or proposed to be undertaken in India. This scheme, therefore leads to expeditious action for resolution of disputes between the Income-tax authorities and the taxpayers, and also helps reduce foreseeable protracted legal proceedings. The scheme was later extended to benefit residents in obtaining a ruling in advance from the AAR in relation to the tax liability of a resident applicant arising out of a transaction which has been undertaken or is proposed to be undertaken by such resident applicant. Further, effective 1 April 2015, resident or non-resident can also approach to AAR for determination or decision by the AAR regarding whether an arrangement, which is proposed to be undertaken by any person being a resident or a non-resident, is an impermissible avoidance arrangement.

7.2 Constitution of Authority for Advance Rulings

The AAR is constituted in New Delhi comprising of a chairman and such number of vice-chairman, revenue members and law members as the central government may, by notification, appoint. A person shall be qualified for appointment as (a) a Chairman, who has been a judge of the Supreme Court or the chief Justice of a High Court or for at least seven years, a Judge of a High Court; (b) Vice-chairman, who has been judge of a High Court (c) a revenue member from the Indian Revenue Service, who is or is qualified to be, a Member of the Board (d) a law member from the Indian Legal Service, who is, or is qualified to be, an Additional Secretary to the Government of India [Section 245-O].

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The law and procedure relating to advance rulings are contained in the following provisions.

- (i) Chapter XIX-B of the Act comprising of section 245N to 245V (both inclusive).
- (ii) Rule 44E and 44F of the Rules; and
- (iii) Authority for Advance Rulings (Procedure) Rules, 1996. [Published vide notification No. G.S.R. 420(E), dtd. 17 September, 1996 and reported in 222 ITR (Stat.) 11

7.3 Purpose and Advantage of the scheme of Advance Ruling

The setting up of an AAR, is an attempt to obtain advance rulings on issues on facts or law, within six months of the application and such rulings are binding both on the Applicant as well as the Revenue. Some of the advantages of seeking rulings from the AAR are:

- (i) The non-resident investor can be sure of its liability towards income-tax even before the start of investment in India. Hence, it can mould its investment plans accordingly and it would be able to avoid long-drawn litigation.
- (ii) The AAR is best suited to sort out complex issues of taxation including those concerning DTAA's which arises as a result of differences of opinion between the tax collectors and the tax-payers.
- (iii) The rulings of the AAR are binding on the Applicant as well as the Commissioner of Income Tax and authorities below him, not only for one year but for all the years unless the facts or the law change; therefore, having obtained the ruling on a given set of facts the taxpayer may be sure about his tax liability in future.
- (iv) The AAR is to pronounce its ruling within six months of the receipt of the application. This enables the investor to obtain the ruling and draw in the details of his transactions without undue delay on this account and with full certainty regarding its tax implications.
- (v) The statute does preclude the AAR, if the circumstances so warrant, from allowing the Applicant to modify or reframe the questions, agreements or projects till the time of hearing. Such a facility is generally not available before other courts or tribunals.

- (vi) Under the rules, the proceedings before the AAR are not open to the general public. Confidentiality of the proceedings is maintained by the AAR as contents of the application are not revealed to any unauthorised person. Thus, there is no danger of the business secrets of the Applicant being leaked out to its rivals or others.
- (vii) Protracted hearing of the application is avoided. If a complicated issue of law or fact is not involved and the point of view put forward by the Applicant is acceptable, a ruling will be pronounced by the AAR without personal hearing. In other cases, the Applicant, if he so desires and, if considered necessary, a representative of the Department will be heard and a reasoned ruling will be given by the AAR in writing.

With effect from 1 October 2014, a resident applicant can also make an application to the AAR in relation to his tax liability arising out of one or more transactions valuing rupees one hundred crore or more in total which has been undertaken or proposed to be undertaken. Accordingly, resident applicant can also apply to bring certainty with respect to taxability of transactions undertaken or proposed to be undertaken.

7.4 Definition of advance ruling and eligibility

The term “advance ruling” has been defined in clause (a) of section 245N to mean (a) the determination by AAR of a question of law or of fact in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident Applicant and also includes the determination of the tax liability of the non-resident arising out of transaction undertaken or is proposed to be undertaken by a resident Applicant with such non-resident; (b) the determination by AAR in relation to the tax liability of a resident applicant arising out of a transaction which has been undertaken or is proposed to be undertaken by such resident applicant (c) the determination by AAR or decision on a question of law or fact relating to computation of total income which is pending before any income tax Authority or the Appellate Tribunal (d) the determination or decision by the AAR about whether an arrangement, which is proposed to be undertaken by any person being a resident or a non-resident, is an impermissible avoidance arrangement.

As per the provisions of clause (b) of section 245N [read with provision of clause (a)], the following can apply for advance ruling (a) a non-resident who

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has entered or proposes to enter into a transaction in India (b) a resident who has entered or proposes to enter into such transaction with the non-resident(c) a resident falling within any such class or category of persons as the Central Government may by notification in the Official Gazette specify. Notification No. 73/2014 dated 28/11/2014 has notified resident whose tax liability arising out of one or more transactions is valuing rupees 100 crores or more. (c) a resident falling within any such class or category of persons as the Central Government may by notification in the Official Gazette specify. Public sector companies have been notified vide notification No. 725(E) dtd. 3rd August 2000 [2000] 245ITR (St.) 5 (d) any person being resident or non-resident in respect of applicability of Chapter X-A.

After reading the provisions of clause (b) of section 245N, the following questions may arise as to:

- **Whether a resident Indian can apply for an advance ruling?**

Yes, a resident Indian can apply for an advance ruling to determine the tax liability of a non-resident arising out of a transaction which has been or is proposed to be undertaken by him with a non-resident. Further a resident who has undertaken or proposes to undertake one or more transactions valuing INR 100 crore or more can approach the AAR to determine his/its tax liability from such transaction/s. Resident assesses who are notified under section 245N(b)(A)(IV) can also apply (Presently only public sector companies have been notified). A resident can also apply to AAR to determine whether an arrangement, which is proposed to be undertaken by it, is an impermissible avoidance arrangement.

- **Whether a resident but not ordinary resident can apply for an advance ruling?**

As a resident but not ordinary resident person would fall within the broader category of “resident”, he would also be entitled to apply for a ruling in situations specified above.

- **Whether a resident, who is liable to withhold tax on the payment to be made to non-residents can apply for an advance ruling?**

Yes. (See Recent Advance Ruling on *McLeod Russel Kolkata Ltd In re. (2008) 215 CTR 230(AAR)*)

- **Whether it is necessary that the Applicant should be non-resident on the date of application?**

It would be very difficult to enforce the condition that an Applicant is a non- resident at the time of making an application as the residential status would be determined on the basis of his stay in India throughout the previous year. Accordingly, if a person were a non- resident in the previous year immediately preceding the previous year in which the application is made, the application would be maintainable. (See *Robert W Smith (1995) 212 ITR 275*, *Monte Harris (1996) 218 JB 413*, *P.NO. 20 of 1995 (1999) 237 ITR 382*)

- **Can a person seek a ruling in respect of his tax liability on his return to India and becoming a resident?**

Yes. (See *Advance Ruling No. P-5 of 1995 (1997) 223 ITR 379*, *Advance Ruling P-12 of 1995 (1997) 228 ITR 61*).

- **Can a ruling be sought even if alternate remedy to make an application under section 195(2) in respect of determination of applicability of TDS provisions or rate of TDS is available?**

Yes, even if applicant has alternate remedy under section 195(2), he can file advance ruling application. (See *Airport Authority of India, IN RE (2008) 299 ITR102 (AAR)*).

- **Can a ruling be sought in respect of an assessment, which has already been completed?**

Clause (i) of the proviso to section 245R(2) specifies that the AAR shall not allow the application where the question raised is pending before any income-tax authority or Appellate Tribunal (except in the case of a resident Applicant falling in sub-clause (iii) of clause (b) of section 245N (i.e., notified by Central Government) or pending before any Court. Accordingly, the AAR can decide an issue pending before an appellate authority in cases of applicants notified by the Central Government under Section 245N(b)(iii).

Further, sub-clause (iii) to clause (a) to section 245N clearly specifies that an advance ruling may be with respect to the determination or decision by the AAR in respect of an issue relating to computation of total income which is pending before any income-tax authority or the Appellate Tribunal.

The Delhi High Court in the case of *Hyosung Corporation*¹ observed that

¹ *Hyosung Corporation v. AAR [2016] 382 ITR 371 (Del)*

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mere fact that the notices under Section 143(2) of the Act was issued prior to the filing of the application before the AAR will not constitute a bar for accepting the AAR application. However, where the notice under Section 142(1) of the Act, raising the various questions that form subject matter of the AAR application, were issued prior to the filing of the applications, the bar gets attracted.

7.5 Procedure in detail for making an application seeking an advance ruling

The application has to be made in the following forms:

Sr. No.	Applicants	Forms
i.	By non-residents	Form 34C
ii.	By resident in relation to transaction with non-resident	Form 34D
iii.	By resident to determine the tax liability arising out of a transaction which has been undertaken or is proposed to be undertaken by such resident applicant	Form 34DA
iv.	By residents notified by the Government (PSC)	Form 34E
v.	By resident or non-resident to determine whether arrangement which is proposed to be undertaken is an impermissible avoidance arrangement	Form 34EA

Application must be made in quadruplicate. It should be presented by the Applicant in person or by an authorized representative or may be sent by post; Every application in the Form as applicable shall be accompanied by the proof of payment of fees as specified below:

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Fees payable along with the application for advance ruling are prescribed under Rule 44E (4) as follows:

Category of applicant	Category of case	Fees (INR)
An applicant referred to in sub-clauses (i) or (ii) or (ia) of clause (b) of s. 245N (Given in paragraph 2 of 7.4)	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought does not exceed INR 100 crore.	200,000
	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought exceeds 100 crore but does not exceed INR 300 crore.	500,000
	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought exceeds INR 300 crore.	1,000,000
Any other applicant	In all cases	10,000

Signature

The application must be signed as per the provisions of Rule 44E(2) of the Rules, which are as follows:

	If the Applicant is	The application shall be signed by
A	An individual If for unavoidable reason, It is not possible for the individual to sign	By the Individual himself By an authorised person (see Note below)
B	An HUF If for unavoidable reason, It is not possible for the karta to sign	By the Karta By the any other adult member the HUF.

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	If the Applicant is	The application shall be signed by
C	A Company If the company has an M.D. If for any unavoidable reason MD is not able to sign or there is no MD	By the M.D. By any director of the company Or By an authorized person (see Note below)
D	A Firm If the firm has a Managing Partner (M.P.) If for any unavoidable reason the M.P. is not able to sign or there is no M.P.	By the M.P. By a partner of the firm (other than a minor)
E	Any other Association of persons	By any member of the Association or by the Principal Officer thereto
F	Any other person	By that person Or By some other person competent to act on his behalf

Note:

Where in case of an individual or a company, the application is signed by an authorised person, such person should be the one who holds a valid power of attorney from the individual/ company and such power of attorney should be attached to the application.

The signature of the person mentioned in the above table should be put on

- (i) the application form;
- (ii) the verification appended to the said form;
- (iii) the annexures to the said application and the statements and documents accompanying such application. [Rule 44E(2)]

Enclosures to the Application

A statement listing question(s) relating to the transaction on which the advance ruling is required. This is optional. The question(s) may be stated in the application form itself. If however, space provided is insufficient, separate enclosure may be used for this purpose.

It may be noted that the question(s) raised in the application should be exhaustively drafted covering all aspects of the issue involved and all alternative claims that the Applicant may wish to make without prejudice to each other. This is because if at a later stage the Applicant desires to raise an additional question which is not set-forth in the application, he may have to obtain permission of the AAR. Granting of such a permission is at the discretion of the AAR (refer Rule 12 of the AAR (P) Rules, 1996).

A statement of relevant facts having a bearing on the question(s) on which the advance ruling is required [Annexure I]

A statement containing the Applicant's interpretation of law or facts, as the case may be, in respect of the question(s) on which the advance ruling is required. [Annexure II]

Where the application is signed by an authorised representative, the power of attorney authorising him to sign.

Where the application is signed by an authorised representative, an affidavit setting out the unavoidable reasons which entitles him to sign.

Separate enclosures may be used where the space provided for any of the items in the relevant forms is insufficient.

All annexures to the application and other statements and documents accompanying the application are also required to be signed by the person who can sign the application [Rule 44E (2)]

In the covering letter, the Applicant may make a request for being heard before pronouncing the ruling.

7.6 Procedure to be followed by the AAR after the filing of the application by the Applicant

- (i) The proceedings before the AAR can be classified in two stages. The first stage is where the application is either allowed or rejected under Section 245R(2) of the Act. The second stage is where the question(s) raised in the accepted application are examined and the advance ruling is determined and pronounced in writing under Section 245R(6) read with Section 245R(4) of the Act.
- (ii) On receipt of the application, the AAR will forward a copy to the Principal Commissioner or Commissioner. The Principal

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Commissioner or Commissioner may be called upon to furnish the relevant records. AAR shall examine the application and such records.

- (iii) After examination, an order shall be passed under Section 245R(2) of the Act to either allow or reject the application. The second proviso to Section 245R(2) of the Act states that at the first stage, an application cannot be rejected without giving the Applicant an opportunity of being heard. By implication, therefore, if the application is to be allowed, there is no compulsion for the AAR to give an opportunity to the Applicant or to the Commissioner of being heard.
- (iv) A copy of order under Section 245R(2) of the Act is sent to the Applicant and to the Principal Commissioner or Commissioner.
- (v) If the application is allowed vide order under Section 245R(2) of the Act, the AAR shall
 - Examine such further material as may be placed before it by the Applicant;
 - Examine such further material as may be obtained by the AAR suo moto; and
 - Pronounce its advance ruling on the question specified in the application within six months of the receipt of the application either with or without giving the taxpayer a hearing.
- (vi) Section 245R of the Act states that at the second stage, the AAR shall provide an opportunity to the Applicant of being heard “on a request received from the Applicant”. In other words, if the Applicant does not make a request for hearing, the AAR is not bound to provide such an opportunity. It is therefore advisable for the Applicant to make a request for hearing in his covering letter while filing the application itself. The notice of hearing can be served to the Applicant or his authorised representative either by hand, through process server, or by registered post or by FAX.

7.7 Opportunity of hearing & right to appoint authorized representative to appear before the AAR

The second proviso to Section 245R(2) of the Act specifies that no application shall be rejected without affording an opportunity of being heard to the Applicant. Section 245R(5) of the Act specifies that the AAR shall

provide an opportunity to the Applicant of being heard, provided a request is made to that effect. Accordingly, if an Applicant wants to be personally heard before a ruling is pronounced, a specific request should be made in the application itself.

Section 245R of the Act provides that the Applicant is entitled to represent his case before the AAR either personally or through an authorised representative. If the Applicant desires to be represented by an authorised representative, duly authenticated document authorising him to appear for the Applicant should be filed.

7.8 Proceedings before the AAR are not open to general public

Rule 24 of Authority for Advance Rulings (Procedure) Rules, 1996, specifies that the proceedings before the AAR are not open to public. Accordingly, no person other than the Applicant, the Commissioner or their Authorised Representatives, without the permission of the AAR can remain present during such proceedings.

7.9 Time limit within which the AAR is required to pronounce its rulings

Section 245R(6) of the Act specifies that the AAR shall pronounce its ruling within six months of the receipt of the application.

7.10 Withdrawal of an application

Section 245Q(3) of the Act states that an Applicant may withdraw an application within thirty days from the date of the application. An Applicant is not permitted to withdraw the application after this period or else the Applicant would be at liberty to withdraw the same any time during the pendency of the proceedings, should he feel at any stage that the ruling is likely to adversely affect him.

7.11 Rejection of an application

Under second proviso to section 245R(2) of the Act, the AAR shall not allow the application where the question raised in the application:-

- (a) Is already pending in the Applicant's case before any IT authority or Appellate Tribunal (except in case of application by public sector company) or any court;
- (b) Involves determination of fair market value of any property; or

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- (c) Relates to a transaction or issue which is designed prima facie for the avoidance of income-tax (except in case of application by public sector company or in the case of application is for determination or decision by the authority whether an arrangement, which is proposed to be undertaken by any person being a resident or a non-resident, is an impermissible avoidance arrangement as referred to in Chapter X-A or not).

However, before rejecting an application, the Applicant should be given an opportunity of being heard.

Further, if the application is rejected, the reason for such rejection shall be given by the AAR in the order.

7.12 Ex-parte Ruling

If on the date of hearing or a date on which the hearing is adjourned, the Applicant or the Commissioner does not appear in person or through an authorised representative, the AAR may decide the application ex-parte on merits. However, if an application is made within 15 days of the receipt of the order and the Applicant or the Commissioner satisfies the AAR that there was sufficient cause for his non-appearance when the application was called for hearing, the AAR may, after allowing the opposite party a reasonable opportunity of being heard, make an order setting aside the ex-parte order and restore the application for fresh hearing [Rule 17 of Authority for Advance Rulings (Procedure) Rules, 1996].

7.13 Situations in which the AAR can declare a ruling pronounced by it as void

Section 245T of the Act, provides that where the ruling pronounced by the AAR has been obtained by the Applicant by fraud or misrepresentation of facts, it may pass an order to declare such ruling as void ab initio on a representation made to the AAR by the Principal Commissioner or Commissioner or otherwise. On the ruling being declared void, all the provisions of the Act shall apply to the Applicant as if such ruling had never been made.

7.14 Powers of AAR

The AAR enjoys all powers of a Civil Court under the Code of Civil

Procedure, 1908 as are referred to in section 131 Act, 1961 [Section 245 U(1)].

As per the provisions of Rule 19 of the Authority for Advance Rulings (Procedure) Rules, 1996, the ruling given by the AAR may be rectified by the AAR at the time before the said ruling is given effect to by the AO. Such rectification, however, is possible in respect of any mistake apparent from the record.

AAR may rectify its ruling in order one or of more the following cases:

- (i) On an application made by the Applicant; or
- (ii) On an application made by the Commissioner; or
- (iii) Suo moto by the AAR.

However, before amending the ruling, the AAR is required to allow the Applicant as well as the Commissioner a reasonable opportunity of being heard.

In case of General Electric Pension Trust, IN RE, (2007) 289 ITR 335 (AAR), it has been held that where there was some material available with applicant at time of hearing but it was not filed then such material cannot be furnished by invoking Rule 19 of the Authority for Advance Rulings (Procedure) Rules, 1996.

Power to modify its rulings

As per the provisions of Rule 18 of the Authority for Advance Rulings (Procedure) Rules, 1996, the ruling given by the AAR may be modified by the AAR at the time before the said ruling is given effect to by the AO. Such modification, however, is possible in cases where there is a change in law or facts on the basis of which the ruling was pronounced.

AAR may modify its ruling under one or of more the following cases:

- (i) Suo-moto by the AAR; or
- (ii) On a representation made by the Applicant; or
- (iii) On a representation made by the Commissioner; or
- (iv) In any other case.

7.15 Binding force of a ruling

Section 245S (1) of the Act specifies that the ruling would be binding on the Applicant who had sought it. Further, the ruling would be binding only in respect of the transaction in relation to which the ruling had been sought. The ruling would also be binding on the Commissioner and the Income-tax authorities subordinate to him, in respect of the Applicant and the said transaction. Therefore, Rulings pronounced by the authorities would not be binding in case of any other taxpayer or the departmental authorities. However, such rulings would have persuasive value and may be relied on by the AAR itself or by the Applicant/ department in their cases.

Section 245S(2) of the Act provides that the ruling shall be binding unless there is a change of law or facts on the basis of which the ruling was pronounced. Accordingly, if there were an amendment to the law, the ruling would not be binding. Similarly, if there is a change in facts — say an agreement is modified; the ruling may not be applicable.

7.16 Binding nature of CBDT Circulars on AAR

As the AAR is an independent authority; circulars issued by the Board may not be binding on it. However, benevolent circulars being for the benefit of the taxpayer would be required to be followed in view of the decisions of the Hon'ble Supreme Court in various pronouncements including that of *UCO Bank vs. CIT reported in [1999] 237 ITR 889 (SC)*.

7.17 Extension of time for completing the assessment by Assessing Officer's in case matter is referred for advance ruling

Explanation 1 to section 153 of the Act provides that the period commencing from the date of filing the application before the AAR and ending with the date on which the order rejecting the application is received by the Commissioner is to be excluded while computing the period of limitation for completing assessment. Similarly the period commencing from the date of filing the application and ending with the date on which the Ruling, pronounced by the AAR, is received by the Commissioner of Income Tax is also to be excluded.

CONTENTIOUS ISSUES

8.1 Payment for Software

As we saw in the Chapter dealing with Royalty and FTS, there are several problems associated with taxation of these incomes. The term 'royalties' is defined differently in different countries, which further augments the problem, especially in classification of the income for the purpose of credit for taxes paid. Some countries tax the income from leasing of equipment also as royalty, whereas the OECD commentary mentions that the income from leasing of equipment should be taxed as business income and not royalty.

As we saw, though royalty is normally allowed as a deduction, in certain cases the payment may be considered as a capital layout and may not be allowed as a deduction. The DTAA's normally provide for the rate of tax to be applied when the income is considered as royalty income, the issue being whether it is to be applied to the gross income or the net income. If the tax is deducted on the gross income without giving any benefit of the expenses in the source State, and the foreign tax credits are computed on the basis of the net tax payable in the resident State, the licensor may not be able to fully utilize the credit for the tax withheld in the source State. There are many source countries e.g. Mauritius, Sweden, Switzerland, etc., which do not tax royalty income of the non-resident. Denmark does not impose a withholding tax on royalty payments to non-residents for copyrights. Royalty is generally taxed in the State of residence of the payer, which is considered as the source State. However, some countries also regard the source State as the State where the property is used or registered. This may lead to multiple taxation due to the State of source claiming a right to tax, the State of residence claiming a right to tax and the State where it is registered (if it is different from the State of residence or source) also claiming a right to tax it, which may be relieved by granting credit by the residence State.

As we saw, software are of two types, systems software, which operates the system, and application software which gives directions to the system to perform tasks e.g. Word, Excel, etc. The software either can be customized

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to the specifications of the buyer or can be off-the-shelf or shrink-wrapped software. The software could be sold completely or only by granting a right to use and upgrade. The sale can be through normal business channels or through the Internet. The debate is really, around whether it represents business profits, payment in the nature of royalty or capital gains on alienation of certain rights. The distinction to be drawn is whether the payment is for copyrighted product or for transfer of the right in a copyright. The copyright protected software is in a way an Intellectual Property Right (IPR).

OECD's Observations

The OECD commentary suggests that the character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protect rights in computer programs either explicitly or implicitly under copyright law.

Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.

In certain types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive

or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.

Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article dealing with Royalty are not applicable. That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The transfer of complete rights over the copyright would be either business profits or capital gains.

The OECD commentary suggests that the payment for the acquisition of partial rights, without the transferor alienating the copyright rights will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. E.g. arrangements that include licenses to reproduce and distribute to the public the software incorporating the copyrighted program, or to modify and publicly display the program. Though the OECD commentary suggests that these payments are royalties, it accepts that there may be classification issues, as copyrights in software do not per se fit into the definition of royalty, since Para 2 requires copyright to be a literary, artistic or scientific work to be regarded as royalty.

OECD also considered the arrangements between a software copyright holder and a distribution intermediary, wherein the software copyright holder will frequently grant to the distribution intermediary, the right to distribute copies of the program without the right to reproduce that program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in

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relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits. This would be the case, regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

The main question to be answered to decide whether the payments constitute royalties is the identification for what the payment was made.

Each case has to be evaluated in the light of its facts. If the customer is electronically allowed to download digital products such as software, images, sound or text for the customer's own use, the payment is essentially for the acquisition of data transmitted in the form of digital signals and therefore, does not constitute royalties but falls under business profits or capital gains.

The act of copying, though it involves the use of the copyright, it is merely the means by which the digital signal is captured and stored. However, this use is not relevant for the classification as royalty, as the payment is for the data. On the other hand, if the payment is for the right to use and commercially exploit the product, which is electronically downloaded, that payment will be royalty. E.g. if a book publisher downloads a copyrighted picture to be published on the book cover the payment is for the use of the copyright and is therefore royalty.

Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. In such cases, where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

Another e.g. given in the commentary to illustrate the position is in the case of mixed contracts in regard to performances by an artist's playing in an orchestra. The fee for the performance along with a simultaneous right to broadcast would fall under the Article dealing with Income of Artists. Where, under the same or different contract, the artist has negotiated that he will be given royalty on public broadcast of the recording, and then payments

received for the broadcast will be royalty. However, if the artist is under contract with the person who owns the recording copyrights, the receipt from broadcast of the recording will fall under business profits or Article 17 dealing with Income of artistes rather than royalties, even if these payments are contingent on the sale of the recordings.

In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7.

A Few Examples in the Indian Scenario

Decisions dealing with taxability of off the shelf / shrink-wrapped software:

Decisions supporting the proposition that payment is not in the nature of 'royalty'

- ***Tata Consultancy Services (271 ITR 401) (SC)***

It is a decision rendered by the Constitution Bench of Supreme Court in a sales tax matter. The appellant therein provided consultancy services, including computer consultancy services. As per their business, they prepared and loaded custom-made software (uncanned software) on customer's computers and sold off the shelf standard software (canned software). The canned software was copyrighted products of Oracles, Lotus, Master Key, etc. The commercial tax officer of Andhra Pradesh assessed sales of canned software to sales tax. The question that arose for the consideration of the Supreme Court was whether the canned software sold by the appellant could be termed as 'goods' and assessed to tax under the Andhra Pradesh General Sales Tax Act, 1957.

The Court held that the expression 'goods', as defined in Article 366(12) of the Constitution of India and as also defined under section 2(h) of the APGST Act, was very wide and included all types of moveable property - whether tangible or intangible; 'goods' for the purpose of sales tax could not thus be given a narrow meaning. The real test whether an article was 'goods' or not

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was whether it was capable of abstraction, consumption and use and whether it could be transmitted, transferred, delivered, stored or possessed. A software programme might consist of various commands, which enable the computers to perform a designated task. However, the moment it was put on a disc and copies were made and marketed, it became chattel exigible to sales tax. Intellectual property, once it was put on to media, whether in the form of books, canvas, computer disc or cassettes and marketed, would become goods.

Based on the above decision, the payment for shrink-wrapped software is akin to payment for purchase of goods and not for use of any copyright.

- ***Motorola Inc, Ericsson Radio Systems AB and Nokia Corporation, (2005) 96 TTJ 1 (Delhi ITAT Special Bench)***

In this case, the payments were made for transfer of a non-exclusive restricted license in the software (not being shrink-wrap software) acquired along with the hardware. The Special Bench distinguished between payments for a 'copyrighted article' and payment for a 'copyright right' and observed as under:

- Merely because the terminology of the Agreement is a 'license', it cannot be said that the payment should be categorized as royalty.
- Under the Copyright Act, 1957, 'copyright' is an exclusive right granted to the holder thereof; whereas in this case, a non-exclusive license to use the software has been given.
- The holder of a copyright can commercially exploit the same by making multiple copies of the software, whereas in the present case, restricted right to use the software for the taxpayer's own purpose and maintenance has been given.
- To constitute a copyright right, the taxpayer should have had one or more of the rights mentioned in clause (a)/(b) of Section 14 of the Copyright Act, 1957 (such as reproduce or make copies of the work); whereas it was clear that the taxpayer has not been given any of the rights mentioned in the section and therefore the taxpayer has not acquired any copyright but only a copyrighted article.

Accordingly, the Special Bench held that the payment is not for any copyright in the software but is only for the software as such as a copyrighted article. It follows that the payment cannot be considered as

royalty within the meaning of Explanation 2 below section 9(1) of the Act or Article 13.3 (dealing with royalty) of the DTAA with Sweden.

This has been upheld by the Delhi High Court in the case of **DIT vs. Ericsson A.B. (2012) 343 ITR 470 (Delhi)**

- ***DDIT v. Reliance Industries Ltd. (Judgement date: October 29, 2010) (Mum ITAT)***

The taxpayer, entered into a license agreement with a US entity for purchase/use of software for its internal use. Pursuant thereto, the taxpayer was granted non-exclusive, perpetual, irrevocable, royalty free, worldwide license to use the specified number of copies of the software enumerated in the agreement solely for internal operation, including web housing services where a software was not directly accessible to third party.

The Tribunal referred to the decisions of the Bangalore Tribunal in the case of *Samsung Electronic Company Ltd. and Hewlett-Packard (India)(P) Ltd.* and the decision of the Delhi Special Bench in the case of *Motorola Inc.* and held that;

- It is now established law that computer software after being put on to a media and then sold, becomes goods like any other Audio Cassette or painting on canvas or a book and therefore, the tax department was wrong in holding that computer software on a media amounts to intellectual property right. Further, the computer software also cannot be considered as a 'Patent' or as 'Invention'.
- Further, the taxpayer purchased a copyrighted article and not the copyright itself and there was no transfer of any part of copyright. Accordingly, the payment received by the US entity cannot be termed as royalty taxable in India. The definition of the term 'royalty' under Article 12(3) of the DTAA is more restrictive than what is provided under the Act and that in such a situation the provisions of the DTAA override the provisions of the Act.

In such a situation, the amount paid by the taxpayer to the US entity will be covered under Article 7 dealing with 'Business Profit'. However, in the absence of Permanent Establishment of the US entity in India, the payment received by the US entity was not taxable in India and hence, the taxpayer was not required to deduct tax at source from the said payment.

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- ***Dassault Systems K.K. (322 ITR 125) (AAR)***

The applicant, a company incorporated in Japan, was engaged in the business of providing 'Products Lifecycle Management' (PLM) software solutions, applications and services. The applicant was promoting the licensed software products mostly through a distribution channel comprising of Value Added Resellers ('VAR'). The product is sold to VAR for a consideration based on the standard list price after deducting agreed discount. The VAR in turn will sell such product to the end-users at a price independently determined by them.

The AAR in this case held as follows:

- Computer software is embraced within the definition of literary work in the Indian Copyright Act. Even otherwise, the computer programme embedded in the software is a scientific work.
- Passing on a right to use and facilitating the use of a product for which the owner has a copyright is not the same thing as transferring or assigning rights in relation to the copyright. The enjoyment of some or all the rights of a copyright is necessary to trigger the royalty. However, non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in a copyright.
- The parting of intellectual property rights inherent in and attached to the software product in favour of the licensee/customer is mandatory requirement by the Act and the DTAA to consider it as a 'royalty'.
- The phrase "including the granting of a licence" in the definition of royalty under the Act, does not mean that even a non-exclusive licence permitting user for in-house purpose would be covered by that expression. It should take colour from the preceding expression "transfer of rights in respect of copyright". Apparently, grant of 'licence' has been referred to in the definition to dispel the possible controversy, a licence – whatever be its nature, can be characterized as transfer.
- The copying/reproduction or storage is only incidental to the facility extended to the customer to make use of the copyrighted product for his internal business purpose. Apart from such incidental facility, the customer has no right to deal with the product just as the owner would be in a position to do. Further, the licensed material reproduced or

stored confined to the four corners of its business establishment on a non-exclusive basis will not attract section 14 of the Copyright Act.

- Section 52(aa) of the Copyright Act makes it clear that the customisation or adaptation, irrespective of the degree, will not constitute 'infringement' as long as it is to ensure the utilisation of the computer program for the purpose for which it was supplied.

Accordingly, the AAR held that no rights in relation to copyright have been transferred nor any right of using the copyright as such has been conferred on the licensee. The payments received by the applicant cannot be construed as 'royalty' taxable within the provisions of the Act or the DTAA.

- **DDIT v Reliance Infocom Ltd. ((2014) 29 ITR (T) 132 (Mumbai))**

The taxpayer, an Indian company, entered into a Wireless Software Contract, for purchase of certain software for the purposes of operation of wireless telecommunication network in India, with Lucent Technologies Hindustan Pvt. Ltd. (LTHPL), an Indian company of Lucent Group, USA. Subsequently the taxpayer also entered into a Wireless Software Assignment and Assumption Agreement with LTHPL and Lucent Technologies GRL LLC (LTGL) USA towards supply of software required for telecom network. Similarly, the taxpayer also entered into a software supply contract with other foreign companies. LTGL was also responsible to provide service for correcting the defective software and providing software and updates without any additional consideration.

During the year under consideration, the taxpayer made application under Section 195(2) of the Act before the AO for seeking nil withholding tax order on payments for purchase of the software. The AO held that the taxpayer was getting only license to use the software and it was in the nature of royalty taxable under the Act and tax treaty. Therefore, withholding of tax was required on payment to foreign supplier. Subsequently, after deducting tax as directed by the AO, the taxpayer preferred appeals before the CIT(A). The CIT(A) observed that the taxpayer was forbidden to decompile, reverse engineer, disassemble, decode, modify or sub-license the software, as per the agreements. Accordingly, CIT(A) held that the amounts paid cannot be considered as royalty as the taxpayer purchased 'goods' which was a copyrighted article and it was not taxable.

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Tribunal's ruling

In the case of Ericson AB8 and Nokia Networks AY¹, the software was supplied along with hardware as part of equipment and there was no separate sale of software. Software was integral part of supply of equipment for telecommunications in those cases. However, in the instant case, software was supplied separately and not along with the equipments.

Separate agreement for supply of software was not only with LTGL but also with various other foreign companies for use in the telecom network by virtue of separate agreements and it indicates that software was not supplied along with hardware.

In this case, the software works on hardware, but the software supplied neither was an integral part of purchase of equipment required nor was embedded software and therefore, the facts in the case of Motorola and Nokia are entirely different. The delivery of the software was separate in the form of CD and was installed in India separately.

LTGL has not been supplying software as part of equipment purchased but as a stand-alone software agreement entered into as per the EULA.

The Karnataka High court in the case of Synopsis International Old Ltd.² held that in terms of the tax treaty, the consideration paid for the use or right to use the confidential information in the form of computer programme software itself constitutes royalty and attracts tax. It is not necessary that there should be a transfer of exclusive right in the copyright. It was held that payment for supply of software and granting of end user software license amounts to 'royalty'.

The Karnataka High Court in the case of Samsung Electronics Ltd. has held that a right to make a copy of the software and use it for internal business by making copy of the same and storing it on the hard disk amounts to use of the copyright under Section 14(1) of the Copyrights Act because in the absence of such a license, there would have been an infringement of the copyright.

In the case of Samsung Electronics Ltd., it was further held that the transaction did not involve a sale of a copyrighted article. The amount paid for supply of the 'shrink-wrapped' software is a combination of the price of the CD, software and the license granted. The right that was transferred was the transfer of copyright and payment made in that regard would constitute royalty.

¹ DIT v. Nokia Networks OY [2013] 212 Taxman 68 (Del)

² CIT v. Synopsis International Old Ltd [2013] 212 Taxman 454 (Kar)

The Tribunal held that the principles laid down by the High Court in the cases of Samsung and Synopsis was applicable to the facts of the present case. The Tribunal also relied on AAR ruling in the case of Citrix Systems Asia Pacific Pte Ltd.³

Further, the decision in the case of Lucent Technologies⁴ has not been upheld by the High Court. Subsequently, the Karnataka High Court in the case of Sunray Computers (P) Ltd.⁵ held that supply of software was to be considered as royalty.

The Tribunal followed the decision of the Karnataka High Court in the case of Sunray Computers (P) Ltd. on same terms of agreement as against the decision of the Delhi Special Bench Tribunal's decision in the case of Motorola, which was rendered in a different fact situation.

In all the tax treaties of India with the countries from where the taxpayer purchased software, the terms of tax treaty are similar, though restricted in meaning when compared to the definition of royalty under the Act.

Under various agreements, entered into by the taxpayer, license to use the copyright belonging to the non-resident was transferred, subject to the terms and conditions of the agreement and the non-resident supplier continues to be the owner of the copyright and all other intellectual property rights.

It is well settled that copyright is a negative right and it is an umbrella of many rights. License was granted for making use of the copyright in respect of shrink-wrapped software under the respective agreement. This license authorises the end user (i.e. the customer) to make use of the copyright contained in the said software, which is purchased off the shelf or imported as shrink-wrapped software.

This amounts to transfer of part of the copyright and transfer of right to use the copyright as per the terms and conditions of the agreement. Therefore, there was transfer of copyright under the agreements entered into by the taxpayer with the non-resident supplier of software.

Accordingly, the payments made by the taxpayer to LTGL/ other suppliers can be said to be payment for the use of or right to use copyright and it constituted royalty under Article 12(3) of the tax treaty. Therefore, withholding of tax was required under Section 195 of the Act.

³ Citrix Systems Asia Pacific Pte Ltd [2012] 343 ITR 001 (AAR)

⁴ Lucent Technologies International Inc. v. DCIT [2009] 28 SOT 98 (Del)

⁵ CIT v. Sunray Computers (P) Ltd. [2012] 348 ITR 196 (Kar)

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- **DDIT v. Solid Works Corporation (ITA No. 3219/Mum/2010)**

The taxpayer was a company incorporated in the USA having tax resident certificate. The taxpayer develops and markets 3D mechanical design solution called as 'Solidworks 2003', which was used for 3D modeling. The software creates 3D models either from scratch or from existing 2D data. The designed data prepared by Solidworks 2003 software provides data, which was 100 percent editable. The software was provided in a packed form to the customers in India along with and pursuant to an End User License Agreement (EULA). The agreement was not physically signed but built in as part of the installation process. The license agreement pops up on computer screen and must be accepted by the user before the user can operate the software. The software provided to the user was a single user license whereby the software could be loaded in one computer or could be used many times which could be loaded on several computers. The taxpayer owns and retains all copyright, trademark, trade secrets and other proprietary rights. The end user was not permitted to make any modification or make works derivative of the software and user was not entitled to reverse engineer, decompile, disassemble or otherwise discover the source code of the software. For the purposes of marketing the shrink-wrap software, the taxpayer had entered into agreement with various distributors/resellers in India. As per the software distribution agreement, the distributor gets right to market, distribute and support the product. However, distributor does not get any exclusive distributor rights. He also does not get any right to disassemble, decompile or reverse engineer the software. Copyright over software remains with the taxpayer. The Tribunal for earlier AYs based on above similar facts held that the amount received for supply of software was not in the nature of royalty within the meaning of Article 12(3) of the India-USA tax treaty (tax treaty). The amount received was in the nature of business income and since the taxpayer did not have a PE in India, the receipts were not taxable in India.

Tribunal's ruling

- The Tribunal held that benefit of non-discrimination Article i.e. Article 24 of the tax treaty was also available to non-residents. Therefore, if there were two views on an issue, the view, which was favourable to the taxpayer was to be applied.
- Regarding the contention of the tax department that the decision of Ericsson A.B. was not related to shrink wrap software, the Tribunal held that the Delhi High Court in the case of Samsung Electronics Co.

Ltd. approved the decision of Dassault Systems K. K., which was a case of sale of shrink wrap software.

- Therefore, relying on the decision in the case of Ericsson A.B., where it was held that the consideration received merely for right use cannot be held to be royalty, the Tribunal held that the said ratio also applied when shrink wrap software is sold.
- Accordingly, the Tribunal held that the consideration received by the taxpayer for software was not royalty. The consideration received was business income in the hands of the taxpayer and since the taxpayer did not have PE in India, business income cannot be taxed in India.
- **DCIT v. ABAQUS Engineering Pvt Ltd [2011-TII-143-ITAT-MAD-INTL]**

The taxpayer is a distributor of software developed by its parent company i.e. ABAQUS Inc. It entered into a Regional Support Agreement (RSA) with ABAQUS Inc for the distribution of software products in India.

The Assessing Officer (AO) examined RSA and observed that:

- The taxpayer was appointed as a distributor by ABAQUS Inc for the sale of software products in India.
- The software products were general products developed by ABAQUS Inc, a licensed copy of which could be sold to the end-users.
- What was sold to the end-user was only a copy of the software product.
- The end user got only a license to use the software product for a particular period.

The AO thereafter sought directions from The Additional Commissioner of Income-tax (ACIT) about the applicability of definition of 'royalty' under Section 9(1)(vi) of the Act.

The ACIT has referred to the RSA and concluded that:

- The taxpayer was given the right to use 'ABAQUS' trademarks and programs in its business for marketing.
- The taxpayer was given the right to reproduce, affix or have affixed copyright.

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- ABAQUS Inc had also allowed the taxpayer to generate license keys for delivery to customers.
- The taxpayer was also allowed to customise and modify the programs for its business.

The ACIT has referred to the decision of Cheminor Drugs Ltd.⁶ and held that the payment made by the taxpayer was to be treated as 'royalty' under Section 9(1)(vi) of the Act. Accordingly, provisions of withholding tax under Section 195 of the Act were applicable on such payments. The AO on the basis of the ACIT's order concluded that what was sold by the taxpayer was only the 'right to use' the licensed version of the software product developed by its parent company. Hence, payments made for supply of software were in the nature of 'royalty' which would be covered under Section 9(1)(vi) of the Act. Since the tax was not deducted, the payment was disallowed under Section 40(a)(i) of the Act.

Tribunal's ruling

The Tribunal concurred with the view of the CIT(A), since the CIT(A) has followed the Delhi Tribunal Special Bench decision in the case of Motorola Inc. Further, following the Motorola Inc decision in the case of TII Team Telecom International, the Mumbai Tribunal held that the payment received for supply of software was not to be treated as 'royalty'.

The Tribunal observed the decision of TII Team Telecom International Pvt. Ltd.⁷ as follows:

- In the case of Gracemac Corporation⁸, a contrary view was taken on the basis of explanation to Section 9(1)(vi) of the Act, which also covers consideration for 'transfer of all or any rights in respect of any copyright, literary, artistic or scientific work'. However, a provision of the Act is larger in scope than the provisions of the tax treaty. The word 'of' between 'copyright' and literary, artistic or scientific work' is also missing in the Act.
- The tax treaty provisions are not in pari materia with the Act. By the virtue of Section 90(2) of the Act, the provisions of tax treaty clearly override the Act.

⁶ Cheminor Drugs Ltd v. ITO [2001] 76 ITD 37 (Hyd)

⁷ ADIT v. TII Team Telecom International Pvt. Ltd [2011] 47 SOT 76 (Mum)(URO)

⁸ Gracemac Corporation v. ADIT [2010] 134 TTJ 257 (Del)

- In the case of Gracemac Corporation, the Delhi Tribunal was of the view that the provisions of the tax treaty and the Act are 'identical'. However, the Tribunal in the case of TII Team Telecom International Pvt. Ltd. has held that the provisions of the Act are wider than provisions of the tax treaty.
- The expression patent, trademark, design or model, plan, secret formula or process, etc., are used together in the treaty. However, when two or more words which are inclined to equivalent meaning, they are deemed to be used in their similar sense. Accordingly, payment made for the software cannot be regarded as 'royalty' since it was not made for a process.
- **Akamai Technologies Inc, In re (2018) 404 ITR 495 (AAR Delhi)**

The taxpayer, a technology company incorporated in USA, is a leading global service provider for accelerating web content and business processes online. The taxpayer developed a product 'Akamai EdgePlatform' (Solution), which pulled content from the customer's web server by replicating the data therefrom and continually monitors the Internet-traffic, trouble spots and overall conditions. The end-users accessed the customer's website through the Solution for a faster browsing experience. The taxpayer entered into a 'services reseller agreement' (Agreement) with its group company (Akamai India) wherein Akamai India was appointed as a non-exclusive reseller authorised to resell the taxpayer's Solution directly to customers in India. Akamai India invoiced the Indian customers on its own account. As per the Agreement, Akamai India would not have any rights, title and interest in any intellectual property and software of the taxpayer, including the Solution. The taxpayer sought an advance ruling on whether the payments received from Akamai India would qualify as royalty or FTS under the Act or the India-US DTAA. The taxpayer also sought a ruling on the constitution of a PE in India under the provisions of Article 5 of the DTAA.

AAR Ruling

- **Applicability of the Copyright Act** - The AAR opined that the essence of the Agreement was not for a computer programme but rather for a facility that was provided by the taxpayer to the customers, using the taxpayer's own private network. Hence, the entire provisions of the Copyright Act did not apply to the transaction.
- **On 'use of'/'right to use' trademark** - Rejecting the Revenue's

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contentions, the AAR held that grant of distribution rights by the taxpayer did not involve grant to use 'trademark' as there was no intention of use of trademark per se by Akamai India.

- **On grant or transfer of right in the 'process'** - It was observed that the Agreement nowhere entailed any grant or a transfer of right in the 'process' nor was there any use of 'process' as was required under the DTAA. The AAR further observed that if at all there was a 'process' which was 'used', it was by the taxpayer itself to render the outsourced infrastructure services to the end user.
- **On 'equipment royalty'** - It was held that since the equipment was used by the taxpayer itself to provide the Solution to Akamai India which was re-sold to the India customers, and Akamai India/Indian customers were not granted any right to use any equipment, the transaction was not covered under the definition of 'royalty'.

Decisions against the proposition that the payment is not in the nature of 'royalty'

- ***M/s Microsoft Corporation vs. Asst. DIT (2010-TII-141-ITAT-DEL-INTL)***

The taxpayer, MS Corp granted exclusive license to its wholly owned subsidiary Gracemac to manufacture and distribute Microsoft retail software products. Gracemac, in turn, granted non-exclusive license to Microsoft Operations Pte Ltd, Singapore (MO) to manufacture (reproduce) Microsoft software in Singapore and distribute the manufactured software products. In exchange, MO paid royalty to Gracemac ranging from 35 percent to 40 percent of net selling price; MO in turn appointed Microsoft Regional Sales Corporation [MRSC], USA as a non-exclusive distributor for selling the software manufactured/reproduced by it. The Microsoft products were sold to Indian distributors by MRSC through its branch office in Singapore.

While the taxpayer contended that the payment in respect of software supplied by MS Corp / MRSC is not taxable in India on the ground that it was for supply of copyrighted article and not copyright, replying on the supreme court decision in the case of *Tata Consultancy Service (271 ITR 401)*, the tax authorities held otherwise; The tax authorities also held that supply of software can also be considered as use / right to use other Intellectual Property Rights (IPR) categories such as Patent, Process, Equipment, giving rise to royalty.

The Delhi Tribunal held as under:

Supreme Court ruling in the case of *Tata Consultancy Services vs. State of Andhra Pradesh (2004) (271 ITR 401)* is not relevant as the same was rendered in the context of sales-tax law and the issue of royalty was not before the Court.

- The characterization of the payment as royalty has to be determined based on the provisions of the Act and the DTAA. Since, under the Indian Copyright Act, 1957, the computer programme has been considered a literary work, it would be incorrect and illogical to interpret the income tax provisions relating to royalties based on the said Act;
- In the present case, the terms of the license agreement with the end user are clear that it is a license and not a sale of software;
- Intent to part with rights of commercial exploitation not necessary under the definition of 'copyright' under the Act. Even grant of one right in respect of a copyright would amount to transfer / use of copyright.
- There can be an overlap between copyright and patent. Since the software is patented in the present case in the US, the payment for the software also constitutes royalty in respect of a patent as well as in respect of an invention.
- Payment for use of computer program is also covered under the ambit of right to use of a "process", since computer program is a set of instructions designed to provide a certain result to the end users.
- The OECD guidelines are not acceptable aid for interpretation of the provisions of the Act or DTAA relying on Supreme Court decision in case of *CIT vs P.V.A.L. Kulandagan Chettiar (2004) 137 Taxman 460 (SC)*;
- The Tribunal went on to observe that even if the provisions of the DTAA between India and US were construed to be more beneficial in this respect, then too the provisions of the domestic law regarding extra- territorial jurisdiction (under section 9 of the Act) would override the provisions of the DTAA since they were introduced after the DTAA came into effect.

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Therefore, the tribunal held that the payment by MO to Gracemac constitutes a royalty under the Act as well as under the DTAA and is taxable in India.

- ***Airport Authority of India (2008-TIOL-10-ARA-IT) (AAR)***

In this case, the applicant, Airport Authority of India (AAI) was a public sector undertaking, seeking ruling on the tax liability of a non-resident US company, namely, Raytheon Company ('RC') with which it has entered into two separate contracts. Under these contracts, RC was to provide software documentation, software, hardware, installation, testing, training, etc., to the applicant. The applicant sought advance ruling on whether payment received by RC under the transaction involving supply and testing of Surveillance Situation Display Data (S-SDD) and supply of DG Servers and related software are liable to tax in India in the hands of the recipient non-resident US Company.

The AAR held that the expression 'royalty' has almost the same meaning, both under the Act and the DTAA. It is the payment made for the conferment of a right entitling the use of a copyright, etc. Since the provisions of the Act and the DTAA are very clear on this point, no reference to the Copyright Act or to any other source appears necessary.

Further, AAR held that the decision in the case of *Tata Consultancy Services (271 ITR 401) (SC)* was not applicable; the legislative scheme of sales tax law and income-tax law are very different. While the object of sales tax law is to tax transactions of sale of moveable properties, income tax law is concerned with taxing incomes and profits of individuals, companies and other entities in whatever manner earned. For this purpose, income has been classified into different types, like business income, income from house property, royalty income, etc., which have been given different tax treatments. Under the sales tax law, the definitions of the terms 'goods' and 'sale' have been kept very wide. Passing of the right to use intellectual property as such has not been regarded as a taxable event. On the other hand, under the Income-tax Act as well as DTAA the payment made in lieu of transfer of right to use copyright is a royalty income. The transfer of disc/floppy on which the copyrighted software has been inscribed is immaterial for this purpose.

Further, the question in the present case was whether the consideration was paid for the use or right to use copyright, in which case it will be royalty income. The AAR observed from the contract provisions that there was no outright transfer of copyright or sale of disc/floppy containing software programme in the present case. The factual background and the legislative

provisions, with reference to which *Tata Consultancy* case was decided, were quite different from those of the present case.

Accordingly, the payment received by RC in respect of software and provision of services of installation, testing and training was held as taxable under the Act read with DTAA.

- **CIT v. Samsung Electronics Co Ltd and others [2011-TII-43-HC-KAR-INTL]**

The taxpayer imported off-the-shelf software from non-residents and made the payment for the same without deduction of tax at source on the basis that the payment does not constitute 'royalty' under the Act as well as under relevant tax treaty.

The AO treated the payment as royalty, both under the Act as well as under the relevant tax treaty and treated the taxpayer as an assessee in default for failure to deduct tax at source.

In connection with the above, the Karnataka High Court, inter alia, observed and held as follows:

Copyright is an umbrella of many rights, and the license was granted for making use of the copyright in respect of the software. The end-user was authorised to make use of the copyrighted software, which would amount to transfer of part of the copyright and the transfer of right to use the copyright

- The right to make a copy of the software and use it for internal business by making copy of the same and storing the same on the hard disk of the designated computer, and taking back up copy would itself amount to copyright work under Section 14(1) of the Copyright Act, 1957 (Copyright Act). The said activity would have constituted infringement but for the license granted.
- It is clear from the provisions of the Copyright Act that the right to copyright work would also constitute exclusive right of the copyright holder and any violation of the said right would amount to infringement under section 51 of the Copyright Act. Therefore, the contention of the taxpayer that there is no transfer of any part of copyright or copyright under the impugned agreements or licenses cannot be accepted.
- Therefore, the payment would constitute royalty within the meaning of the relevant tax treaty and the taxpayer was liable to deduct tax at source under section 195 of the Act.

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- Reliance cannot be placed on the decision in the case of *Tata Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 401 (SC) since the question involved in said case was whether the transaction in question was sale for the purpose of Andhra Pradesh General Sales Tax, 1957.
- **ING Vysya Bank Ltd v. DDIT [I.T.A. No.160/2010, dated 5 August 2011 (AY 2008-09)]**

The taxpayer is engaged in the business of banking in India. ING Computer lease, Belgium (ICLB), a Belgium entity entered into a license agreement with Oracle Netherlands BV. As per the agreement Oracle Netherlands BV sold the licenses to use the 'oracle database software' and performance of technical support services with whole ING group. Oracle Netherlands BV granted the license to ICLB on one-time payment. Consequently, ICLB entered into a sub-licensing agreement with other ING associated companies to provide the use of such license and the enjoyment of supplier related maintenance and support to the sub-licensees. The sub-licensees were required to pay one time charge for each sub-license. The AO observed that the taxpayer availed 39 CPU licenses and 320 Oracle named user licenses, which contain the 'oracle database software', and other licenses. All the software were directly downloaded from the website. Further, the taxpayer made remittances to ING Zurich, a Switzerland entity without deducting tax at source. The AO further observed that the taxpayer purchased the 'shrink wrapped computer software' from ING Zurich, which was also available off the shelf in the market. Accordingly, the AO held that such payment was in the nature of 'royalty' as per the provisions of the Act as well as the tax treaty. Therefore, the taxpayer was required to deduct tax at source before making the remittances. The AO, on a perusal of the Chartered Accountant (CA) certificate noticed that remittances were made towards the purchase of software license and the taxpayer has not deducted tax on the said remittance. Accordingly, he initiated proceedings under Section 201(1) of the Act on ING Vysya Bank, an Indian entity. The CIT(A) relying on the decision of Samsung Electronics Co Ltd.

Tribunal's ruling

The Tribunal observed that the taxpayer had purchased the license from ODB to use its software and this license is for the purpose of its usage only. The software is not 'tailor made' specifically for the taxpayer and the taxpayer had only a limited right to use the software and could not alter or modify the software or sell the license to any other person.

When the right to use of software is limited one i.e. only to use and operate, it could not be said that there was any transfer of intellectual property. The licensed software had been developed by Oracle was no doubt for the use of intellectual property but the product was only permitted to be used and operated by the taxpayer. However, the taxpayer had no right to modify or transfer the said license. Thus, there was no transfer of intellectual property.

The Tribunal observed that whenever 'royalty' is paid to or received by a person who is a resident of another country with which there exists a tax treaty, the definition of 'royalty' as contained in the relevant tax treaty will prevail, if it is more beneficial to the taxpayer.

In case a payment is made to a non-resident, though it fits into the definition of 'royalty' under the Act, but if it does not fit into the definition of 'royalty' under the tax treaty, then the said payments would not be taxable in India unless the payment is attributable to the Permanent Establishment (PE) of a non-resident in India.

The Tribunal held that license to use the software developed by Oracle also falls within the definition of 'royalty' specified under Explanation to Section 9(1)(vi) of the Act. Thus, it was clear from the definition that one-time payment made by the taxpayer for obtaining a license of 'oracle database software' was 'royalty' and it was taxable in India.

Article 12(3) of the tax treaty provides that any payment made for the use of or right to use of the properties mentioned therein would be considered as 'royalty'. Accordingly, in the instant case also the payment made by the taxpayer would be covered under the definition of 'royalty'.

Both the definitions (i.e. under the Act as well as the tax treaty) are similar and encompass the payment for the use of and the right to use of any intellectual property mentioned therein. Accordingly, the license granted by ODB for use of its software by the taxpayer constituted 'royalty'.

The Tribunal observed that the decision of Samsung Electronics Co Ltd relied by the CIT(A) has reversed by the Supreme Court in the case of GE India Technology Centre and remitted back to the Karnataka High Court to decide on the taxability of the remittances. Therefore, the decision of the Karnataka High Court is no longer applicable.

The Tribunal held that the taxpayer was required to deduct tax at source before making the remittances. However, the taxpayer had failed to withhold tax and it would be treated as an 'assessee in default' under Section 201(1) of the Act.

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Other decisions on 'royalty'

▪ *Google India (P.) Ltd. v. JDIT [2018] 194 TTJ 385 (Bang)*

The taxpayer (Indian company) is a wholly-owned subsidiary of Google International LLC, U.S. (Google U.S.). The taxpayer is engaged in the business of providing Information Technology (IT) and Information Technology enabled Services (ITES) to its group companies. It also acts as a distributor for Adwords Program in India.

On 1 April 2004, the taxpayer entered into a service agreement with Google U.S. to render software development services. The taxpayer's R&D units located at different locations in India provide IT services including application development, maintenance and testing services. Similarly, the taxpayer entered into a service agreement with Google Ireland Limited (GIL) to render IT-enabled services. Its service centres at two different locations in India provide ITES service relating to the administration of advertisements in accordance with the guidelines provided by GIL and provide customer support services.

Under the Google Adwords Program Distribution Agreement dated 12 December 2005 entered into between the taxpayer and GIL, the taxpayer was appointed as a non-exclusive authorised distributor of Adwords Program to the advertisers in India. Subsequently, the taxpayer entered into a Google Reseller Agreement on 1 July 2012, pursuant to which the earlier agreement dated 12 December 2005 was terminated and the taxpayer was appointed as non-exclusive, authorised reseller of online advertising space to advertisers in India under the Google Adwords Program.

Under the Adwords Program distribution agreement, the taxpayer acquired the marketing and distribution rights of Adwords program for the territory of India from GIL. The taxpayer is remunerated on cost plus market basis for the distribution services under Adwords Program. During the Financial Year 2012-13, the taxpayer has made payments to GIL for marketing and distribution rights of Adwords Program without deduction of tax at source. The taxpayer claimed that the amount paid to GIL was not in the nature of royalty under the provisions of the India-Ireland tax treaty.

Tribunal's ruling

On perusal of the Adwords distribution agreement and the service agreement, it has been observed that the taxpayer has not only purchased the advertisement space from the GIL and resold it to the advertisers against certain advertisement

charges but the taxpayer was required to provide on sale and post-sale technical services to the advertiser and the GIL, which are not possible without resorting to the service agreement. In fact, the taxpayer obtained the advertisement space under the Adwords distribution agreement and resell it to different advertisers along with on sale and after sale services.

With the aid of ITES division, the taxpayer is required to execute the programs and also provide all technical support to the advertisers and GIL. As per the agreement with the advertisers, the advertisers are required to approach only the taxpayer and not the GIL. The taxpayer is in fact required to sort out all glitches to be faced by the advertisers while putting the ads on the Adwords Program. Having examined functioning of the taxpayer, the literatures in the form of book, it has been observed that Google Adwords Program is a complex program.

While discharging its obligation under the Google Adwords Program and service agreement, the taxpayer has an access to the trade marks, IPRs, derivative works, brand features and the confidential information of the GIL. Therefore, it cannot be called that whatever payments were made by the taxpayer to GIL was simpliciter a payment towards the purchase of Adwords space from the GIL for its resale to advertisers.

Therefore the payments of advertisement fees made by the taxpayer after retaining a particular part is royalty in the light of definition of royalty given under Section 9(1)(vi) of the Act and the tax treaty. Accordingly, it has been held that the payment made by the taxpayer to GIL is a payment of royalty and as per provisions of Section 9(1)(vi) of the Act, it is an income deemed to accrue or arise in India.

- ***Godaddy.com LLC v. ACIT [2018] 170 ITD 217 (Del)***

The taxpayer is a Limited Liability Company (LLC) located in the U.S. It is engaged in the business as accredited domain name registrar authorised by Internet Corporation for Assigned Names and Numbers (ICANN). The taxpayer is a registrar of the customers who need these services and provide the services to its customers. ICANN is the central organisation who appoints a registrar like the taxpayer and charges fee under a fixed predetermined formula.

As per the agreement between the taxpayer and ICANN, the taxpayer has the right to register, assign, transfer and manage specific domain names. The clients all over the world apply for services as per proforma given by the taxpayer and pay fees for the same. One part of the fees is allegedly received by the taxpayer for web-hosting which is being offered for tax as royalty and the other part is

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taken for domain name registration. During the Assessment Year 2013-14, the taxpayer received income from domain registration fees which was claimed to be not taxable in India.

The Delhi Tribunal, while relying on the decisions of the Supreme Court and other High Courts¹, held that the rendering of services for domain registration is rendering of services in connection with the use of an intangible property which is similar to trademark. Therefore, the charges received by the taxpayer for services rendered in respect of domain name is royalty within the meaning of Section 9 (1)(vi) read with Clause (iii) of Explanation 2 of the Act.

- ***Modern Threads (India) Ltd. v. DCIT (1999) 63 TTJ 601 (Jaipur (TM))***

The Jaipur Bench of the Tribunal in the context of the India-Italy DTAA held that the payment for supply of technical know-how and basic engineering documentation was business profits in the hand of the non-resident. Modern Threads (India) Ltd. (hereinafter referred to as the "sub-licensee") entered into a contract on 15 December 1995 with Tecnimont SPA of Italy (hereinafter referred to as "sub-licensor") for grant of rights and sub-licence to use the process and technical know-how and supply of basic process engineering documentation. The Ministry of Industry in its letter dated 27 March 1996, conveyed the approval to the project. Sub-licensor had the availability and access to technical information and know-how of a confidential nature related to the process for the production of purified terephthalic acid ("PTA") owned by Inca International SPA of Italy (hereinafter referred to as "licensor"). The licensor authorised the sub-licensor to grant such sub-licence and rights under the know-how to the sub- licensee. The sub-licensor in the contract agreed to grant rights and sub-licence to use and practice the process in India and to use and sell the product manufactured and also to supply the know-how and documentation for the design, construction and operation of the plant on various terms and condition set out in the contract agreement. In consideration of the rights and sub-licence granted the taxpayer (sub- licensee) was required to pay to the sub-licensor US \$ 25 million net of taxes imposed in India. The Tribunal held that the payment linked to the production or profits earned through use of process or secret formula, patent, copyright etc. is directly linked to the product and the same would no doubt be taxed as royalty as per Article 13 of the DTAA. The controversy, however, related to the payment to be made in installments to the sub-licensor for supply of technical know-how of US \$ 25 million and also for

supply of basic process engineering documentation of US \$ 3.5 million for designing, construction and operation of the plant. This payment did not relate to the use of any process, secret formula or patent for production of any commodity but was for creating an asset in the shape of a plant, designed, constructed and operated as per the technical know-how developed by the Licensor and basic process engineering documentation provided by the sub-licensor and this payment is required to be made in installments by the date of completion and start of the plant for production of PTA. And therefore did not fall within the term "royalty" as defined in clause 3 of Article 13 of the DTAA. As the sub-licensor has supplied by way of sale to the taxpayer-company the technical know-how as well as basic process engineering documentation for setting up of the plant, the consideration received would undoubtedly be a business profit in the hands of the sub-licensor and the sub-licensor having no permanent establishment in India such business profits are liable to be assessed in the hands of the sub-licensor in Italy.

- ***Graphite Vicarb India Ltd. v. ITO [1992] 43 ITD 28 (Cal)(SB)***

The taxpayer was an Indian company, which had entered into a collaboration agreement with Messrs. Vicarb S. A., France, on August 10, 1981. Under that agreement the foreign company was to transfer outside India technical know-how for the manufacture of impervious graphite equipment and grant to the taxpayer the exclusive right to use the said know-how for which the taxpayer should pay a lump sum consideration of Rs. 1 million (subject to tax). The agreement provided for a royalty of 3 per cent. (Subject to tax) for the right to use the know-how granted.

The Tribunal held that under the DTAA between India and France the industrial or commercial profits of an enterprise of one of the Contracting States could not be subjected to tax in the other Contracting State, unless the enterprise has a permanent establishment situated in that other Contracting State. The term "industrial or commercial profits" shall not include income from royalties. The DTAA defines "royalties" to mean payment of any kind received as consideration for the use of or for the right to use any copyrights, designs, plans, etc. In other words, the consideration for the right to use technical know-how will be royalty, which is subjected to tax in both the countries whereas the consideration for acquisition of the know-how would not be a royalty and consequently it would be a commercial profit exempt, as the foreign company did not have a permanent establishment in India.

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- ***CIT v. Gilbert and Barker Manufacturing, USA [1978] 111 ITR 529 (Bom)***

A foreign company entered into a contract with an Indian company to manufacture, sell and service gas pumps for which the Indian company was to pay 5 percent of the sale price of the pumps. The High Court held that the payment received was for the business activity of the non-resident and was taxable as business income after allowing deductions as supply of know-how on a license basis can be regarded as carrying on a business. The license granted to make use of the know-how was to be applied in trade and the non-resident had not parted with any capital asset.

- ***Rolls Royce Ltd. v. Inspector of Taxes [1965] 56 ITR 580 (HL)***

Lump sum payments received for supply of technical know-how, plans for the interchange of staff to enable them to manufacture specified types of aircraft engines was a trading receipt.

- ***CIT v. Koyo Seiko Co. Ltd. [1998] 233 ITR 421 (AP)***

The non-resident company Koyo Seiko Limited entered into a collaboration agreement dated October 14, 1963, with the Andhra Pradesh Industrial Development Corporation Limited for assisting Andhra companies in the project programme of establishing bearing factory in India. The agreement provided for payment of a technical fee, payment of royalty as well as payment of fee for preparing a project report. The only point in dispute was with reference to the taxability of the technical fee, which was received for parting with the know-how of the Japanese company. It was held that the Japanese company had to supply drawings and data on contracted projects and thus share a secret process for a period of agreement, which was for nine years. Since the Japanese company, which had exclusive knowledge, lost part of it in India, the fee received, as compensation was a capital receipt and could not be taxed in India. It was also found that as far as service rendered by the technicians deputed to India was concerned, they were paid separately and in fact, no services were rendered in India with reference to the earning of the technical fee the amount received as technical fee was held to be only a capital receipt for sale of technical know-how abroad and, therefore, not taxable in India.

- ***CIT v. Krebs and CO. [1998] 229 ITR 615 (MP)***

Krebs was a non-resident company and National Newsprint and Paper Mills Limited (for short "Nepa Mills") was its agent within the meaning of Section

163 of the Act. An agreement dated 5 May 1975, was entered into between the taxpayer, Krebs, on the one hand, and Nepa Mills, on the other, for supplying know-how, complete engineering and services for the extension of the existing chlorine and caustic soda plants. The taxpayer undertook to perform all engineering services necessary for the supply of imported items and for procurement of the indigenous items by the Nepa Mills. The taxpayer also undertook to provide technical information, drawings, specifications and operating instructions to enable the Nepa Mills to erect, repair and maintain the plant and on its part the Nepa Mills undertook to use such drawings solely for the purpose of erection, repair and maintenance of the plant and equipment to be supplied by the taxpayer, and not to use them or pass them on to other parties for use in the construction or operation of any other plant. It was also agreed that Nepa Mills would not extend the plant by using the taxpayer's design and processes without having reached a written agreement with the taxpayer. The taxpayer also undertook to place at the disposal of the Nepa Mills one-erection supervisor for nine months and one chemical engineer for two months to supervise erection and starting of the plant.

The High Court agreed with the finding of the Tribunal, held that there was transfer of certain rights for exclusive use of those rights in respect of model, design and the process for expansion of the plant. The transfer was not an out and out transfer. It was restricted by certain conditions. Therefore, that a part of the amount would be towards technical services and the rest would be charged as royalty within the meaning of Explanation 2 to Section 9(1)(vi) of the Act and thus the taxpayer had income by way of royalty. The payment for the supply of technical information, drawing, specification for erections and repairing and maintenance of the plant was held as business profits and not taxable.

- ***DDIT v. Preroy AG (39 SOT 187) (Mum ITAT)***

The taxpayer, a company incorporated in Switzerland, was engaged in the business of providing strategic consulting services like advising clients in matter related to strategic issues such as establishing joint ventures, technology transfers and related matters, etc. The taxpayer entered into a strategic consulting services agreement with an Indian company, Stock Traders Pvt. Ltd. (STPL), to render services under the agreement at any place outside India, depending on the requirements of STPL.

- The Tribunal held that the provision of service may require technical input by the person providing the service, does not per se mean

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that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of Article 12 4(b) of the DTAA. Further, it was clear from the nature of service that the technical knowledge, experience, skill continues to remain with the taxpayer even after conclusion of the agreement and nothing was made available to STPL by the taxpayer. Therefore, the receipts in question cannot be said to be in the nature of FIS.

- The Tribunal, based on the OECD Commentary on Article dealing with royalty observed that in a contract involving the provision of know-how, the emphasis is on enabling the recipient to use the know-how on its own account. As against this, in a contract for rendering advisory services, the consultant uses his skills to merely execute certain work for the service recipient. There is no effort involved in educating the user to reproduce the processes involved in rendering the services. In other words, a consultant may give a certain advice based on his experience. However, there is no imparting of experience in rendering advisory services.
- Consideration for information concerning industrial, commercial and scientific experience is to be regarded as Royalty only if it is received for imparting of know-how. However, providing strategic consulting services, which may entail the use of technical skills and commercial experience by a strategic consultant, does not amount to know-how being imparted to the buyer of the strategic consulting services. Accordingly, the Tribunal held that since the taxpayer was only rendering consultancy services and was not imparting any know-how to STPL, the amount received by the taxpayer cannot be considered to be in the nature of Royalty.
- ***CIT v. Neyveli Lignite Corporation Ltd. (2000) 243 ITR 459 (Mad.)***

The taxpayer was engaged in the mining of lignite. It entered into an agreement with a Hungarian company, for acquiring steam-generating plants with auxiliaries for more efficient running of the business. The AO held that the amounts paid under the contract were income that had accrued to the Hungarian company in India, and, hence, the taxpayer was required to deduct tax at source on such payments. The Tribunal held that the payment could not be regarded as royalty. The term “royalty” normally connotes the payment made by a person who has exclusive rights over a thing for allowing another to make use of that thing which may either be physical or intellectual

property or thing. The exclusivity of the right in relation to the thing for which royalty is paid should be with the grantor of that right. Mere passing of information concerning the design of a machine, which is tailor-made to meet the requirement of a buyer, does not by itself amount to transfer of any right of exclusive user, to render the payment made therefore being regarded as “royalty”. On a reference, the Court observed that the price paid by the taxpayer to the supplier was a total contract price covering all the stages involved in the supply of machinery from designing to commissioning. The design supplied was not to enable the taxpayer to commence manufacture of the machinery itself with the aid of such design. The design referred to in the contract was only the design of the equipment required to be manufactured by the supplier abroad and supplied to the purchaser. There was no transfer or licence of any patent invention, model or design owned by the supplier that the buyer was permitted to exploit. The information concerning the working of the machine was incidental to the supply as the machinery was tailor-made for the buyer. Unless the buyer knew the way in which the machinery had been put together, the machinery could not be maintained in the best possible way and repaired when the occasion arose. The Court concluded that Section 9(1)(vi) and (vii) of the Act would have no application as the design was only preliminary to the manufacture and not integrally connected therewith. Therefore, the payments made were not liable to deduction of tax at source.

- ***CIT v. HEG Ltd. [2003] 130 Taxman 72 (MP)***

The taxpayer, a company, paid a certain amount to a US firm for purchase of some information. The AO held that the said transaction involved imparting of information concerning technical, industrial, commercial or scientific knowledge, experience or skill, and therefore, the payment was royalty for purchase of data of confidential nature and the taxpayer was liable to deduct TDS thereon. The CIT (A) affirmed the order of the AO.

The Tribunal held that there was nothing secret or confidential in the booklet, which was supplied to the taxpayer, and the correspondence between the taxpayer and the firm was only information in the form of collection of data on the subject available in the market and therefore the payment was not royalty.

The High Court held that every payment against information could not earn the status of royalty. To have royalty status it has to have some special features. The information must be based on some expertise or skill. Every information merely because it concerns the industries on commercial venture,

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would not be “royalty”. In the instant case, the compilation of data, which was received by the taxpayer, was not produced before the Tribunal and it had no occasion to scrutinize the same.

The High Court noted the observations of the Tribunal referred to above. However, if held that as the booklet was stated to have not been produced before the Tribunal and a finding had been recorded, the order of the Tribunal was to be set aside and the matter was to be remitted to the Tribunal.

- ***Factset Research Systems Inc (2009) 182 Taxman 268 (AAR)***

The taxpayer in this case was a body corporate incorporated in USA. It maintained a database, which was located outside India and which contained the financial and economic information, including fundamental data of a large number of companies worldwide. The database contained the published information collated, stored, displayed in an organised manner. Its customers were financial intermediaries and investment banks. The taxpayer provided access to its database to the customers globally (including customers based in India) and received subscription fees in this regard.

- The AAR observed that in order to determine a term that is undefined under the taxation law, the definition should be sought from the law governing the subject matter. Accordingly, the term copyright should be construed as per the provisions of the Copyright Act. The computer database, by an amendment to the Copyright Act, falls within the ambit of literary work.
- Making this centralized data available to the customer does not mean that the copyright in the database is being parted in favor of the customer. The term ‘license’ used in Section 9(1)(vi) of the Act refers to an entitlement attached to a copyright so as to enable the licensee to commercially exploit the limited rights conferred on him.
- The AAR observed that the Act and the DTAA both refers to the information concerning industrial, commercial or scientific knowledge or experience’. The clause does not imply mere imparting of such knowledge or experience. The taxpayer does not share its experiences, techniques or methodology employed in evolving the database with the subscribers. The information that is available in public domain is collated and presented in a proper form by applying the taxpayer’s methodology. This does not amount to imparting of information concerning the taxpayer’s experiences, techniques or methodology employed in evolving the database with the subscribers.

- The AAR, in this context, also referred to the OECD Commentary on 'treaty characterisation issues arising from E-commerce' to indicate that the Data retrieval or delivery of exclusive or other high-value data will be taxable as business profits and not as royalty or technical fee.

Accordingly, the AAR held that the subscription fee received from customers was not taxable in India as royalty. It is liable to tax as business income only if a PE exists, and since the PE does not exist, the income is not subject to tax in India.

- ***Gartner Ireland Ltd. v. DDIT (ITA No. 1452/Mum/08) (Mum ITAT)***

The taxpayer, a tax resident of Republic of Ireland, was engaged in the business of distributing Gartner Group's research products in the form of subscriptions. The research products consisted of qualitative and quantitative research that include statistical analysis, growth projections and market share rankings of suppliers and vendors of IT manufacturers and the financial community. The taxpayer sold subscriptions to its Indian customers/subscribers, which enabled them to access Gartner's research products over the internet from its data server, which was located outside India. The Indian subscribers paid the subscription/access fees to the taxpayer in terms of service agreement.

The Tribunal observed that the taxpayer had received similar subscription amounts from Wipro Ltd. under identical agreement. In the case of Wipro Ltd. it was held as under:

- The payments were towards obtaining market data and clients strategy details etc., which were publications and not information or advice given individually. The information was available on subscription to anyone willing to pay.
- It was copyrighted information and could not be passed on to anyone else.
- There was no licence to anyone to use it in any manner or quote to anyone else and the access was restricted to specific individuals.
- It was for use of a copyrighted article and not for transfer of right in the copyright in the article.
- The copyright must be of a literary, scientific or artistic work, which was not the case of the taxpayer, and therefore, payments of subscription fell outside the scope of definition of royalty under the DTAA.

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Based on the decision of Wipro Ltd, the Tribunal held that the subscription/access fees received by the taxpayer from Indian clients were not in the nature of Royalty under the DTAA.

- ***Advance Ruling P No. 475 of 1999, 255 ITR 354***

The applicant, a company resident of the United States of America (US), supplied engineering drawings and designs for the construction of a Hydrogen Generation Plant to Linde Process Technologies India Ltd (Indian company), a resident of India. The Indian company initially deducted tax at source from the first two installments of the sale consideration at the rate of 15 percent. Subsequently, at the request of the applicant, it obtained an order under Section 195(2) of the Act, which held that no tax was to be deducted from the payments made to the applicant.

The applicant approached the AAR for seeking a clarification on the issue of taxability of the sale consideration mentioned above, in India.

The questions put before the AAR were:

- Whether the applicant is liable to tax on the amount received from the Indian company towards consideration for the sale of engineering drawings and designs?
- Whether the applicant is entitled to the refund of the tax deducted by the Indian company calculated at 15 per cent on the part of the remittance together with interest on delayed payment of tax deducted at source, already deposited with the bank by the Indian company?

The applicant submitted that it did not have any income from any source in India, other than the income relating to the consideration for sale of engineering drawings and designs to Linde Process Technologies India Ltd and other transactions involving the sale of machinery and equipment.

The Revenue contended that the consideration received by the applicant constituted 'fees for included services' defined in Article 12(4)(b) of the Indo-US DTAA which defines 'fees for included services' as including consideration for 'making available' technical knowledge skill know how or processes or consist of the development or transfer of a technical plan or a technical design.

The AAR rejected the Revenue's contention on the following grounds:

- The transaction covered by the application to the AAR was an out

and out sale of engineering drawings and designs by the US resident applicant to an Indian company.

- The payment was not made for any service to be rendered by the American company. It was not a case of licensing agreement or sale being coupled with a restrictive clause. The purchaser was entitled to use the engineering designs and drawings as it liked and was entitled to sell or transfer the properties purchased.
- For a payment to be classified as 'royalty', the payments must be for the use of the right to use of the things specified in Article 12(3)(a) and not for an out and out sale thereof. However, there is a clause relating to alienation of property. That clause which is the concluding words of paragraph 3(a) speaks of "gains derived from alienation of any right or property, which are 'contingent' on the productivity, use or disposition thereof." In the instant case, the AAR had not been shown any such contingent clause. Thus, the payment could not be treated as 'royalty'.
- Similarly, the payments made to the applicant could not be classified as
- 'fees for included services'. Even if the out and out sale included rendering of engineering services, these services could not be anything other than "services that are ancillary and subsidiary as well as inextricably and essentially linked to the sale of property." Therefore, such services clearly fell within the exclusionary clause of paragraph 5 of Article 12.
- Article 12(5) specifically excluded payments for sale of property. The payment being for the sale of property was specifically excluded from the definition of 'fees for included services'.

The AAR also examined the decisions of the Supreme Court in the case of *CIT v. Elecon Engineering Ltd.* 166 ITR 66 (SC) and *Nippon Electronics Ltd. v. CIT* 116 ITR 231 (SC) where the nature of designs, drawings and patterns had been examined and a distinction between the sale of property and allowing use of property and technical know-how had been brought out. The AAR concluded that payment in this case being an out and out sale of property could not be treated as a licensing fee or royalty.

Thus, the consideration received by the applicant from the sale of drawings and designs was held as not taxable in India.

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- ***Kirloskar Oil Engines Ltd. v. DCIT [2002] 83 ITD 436 (Pune)***

The taxpayer, a company, had entered into a collaboration agreement with SEMT Pielstick, France for the manufacture of SEMT Pielstick Diesel Engines in India. Under the agreement, SEMT was to supply all the technical know-how including drawings and designs for which a production based royalty was payable for a period of 10 years.

During the year ended 31 March 1991, the Company received an order from GR Ltd for manufacture of two Pielstick engines. These engines were to be fitted on a naval ship. The Company had the basic technology to manufacture these engines. However, since the engines were to be fitted on the naval ship it required certain critical performance criteria and frequency calculations for which the Company did not possess the required expertise. SEMT agreed to render these services for a fee of FF 45,000.

Before the AO, the company contended that the payment of FF 45,000 was in the nature of technical fees and not royalties. Therefore, no tax was deductible as the technical fees were taxable only in France according to article VI of the DTAA between India and France at the relevant time.

The AO treated the payments as royalties, as these services were for imparting of information. He therefore directed the company to deduct tax as per section 195(2) of the Act. The CIT(A) upheld the order of the AO. According to the CIT(A), Explanation 2 to section 9(1)(vi) of the Act covered these payments as royalties.

The Tribunal allowed the appeal of the company and held that:

- It is a settled law that provisions of the DTAA shall prevail over the provisions of the Act. The payments made by the company were not in the nature of royalties under the Article VII of the DTAA.
- The definition of 'Royalties' under Article VII of the DTAA envisaged extended or perpetual use of the technology provided by the payee.
- Technical services meant services rendered only for a one-time job and these were useful for, and only for, the purpose and application for which they were rendered.
- In the instant case, preparing calculation report to meet a specific problem was essentially rendering of a technical service and could not be equated to 'imparting' information for a consideration in the nature of royalty.

The Tribunal followed the decision of Calcutta Bench in *ITO v. Voest Alpine Indus GmbH, Austria* [1998] 67 ITD 219.

- ***Brown and Root Inc. v. CIT AAR P.No.353 of 1997 103 Taxman 515***

An Indian company was awarded a contract for installation of sub-sea gas pipeline it sub-contracted part of the work to Hyundai Heavy Industries Co. Ltd. a Korean company, which in turn sub-contracted it to the taxpayer a US company. The issue was whether the amount received by Brown & Root was exempt under the Indo-US DTAA and not taxable in India in view of the fact that the US Company did not have a PE in India. The tax authorities contended that the vessel constituted a PE and alternatively the amount received was royalty as it was a contract to provide commercial equipment. The AAR held that as the contract was less than 120 days the company had no construction PE in India and the vessel could not be treated as a PE as there was a specific clause of construction PE under which the presence of PE had to be examined and a specific Article would override a general Article. The AAR held that the income constituted business income and not royalty and was not taxable in the absence of a PE.

- ***Ishikawajma Harima Heavy Industries Ltd [288 ITR 408] (SC)***

The taxpayer, a foreign company incorporated in Japan formed a consortium with five other enterprises. The consortium was awarded a turnkey contract from an Indian company for setting up Liquefied Natural Gas (LNG) receiving, storage and regasification facility in India. The description of the work allotted to the taxpayer was categorized as (i) offshore supply (ii) offshore services (iii) onshore supply (iv) onshore services and (v) construction and erection. In offshore supply of equipment and material, the goods were supplied on CFR basis from outside India. The property in goods passed to the Indian company on high seas outside India. Offshore services comprised of design and engineering including detail engineering in relation to supplies, services and construction and erection and any other services, which were to be rendered from outside India.

With respect to taxability of income received from offshore services, the

Supreme Court laid down as under:

- Sufficient territorial nexus between the performance of services and territorial limits of India was necessary to make the income taxable in India.

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- For Section 9(1)(vii) of the Act to be applicable, it was necessary that the services should not only be utilized within India, but should also be rendered in India
- Section 9(1)(vii)(c) of the Act would not apply since there was nothing to show that the income derived by a non-resident company, irrespective of where service was rendered, was utilized in India.
- Article 7 of the DTAA was applicable in the present case and it limited the tax on business profits to that arising from the operations of the PE. The entire services were rendered outside India and were not connected with the PE. Thus, no income was attributable to the PE and was not taxable in India.

However, it may be noted that the Finance Act, 2010 amended the Explanation to Section 9(2) of the Act with retrospective effect from 1.6.76 to specifically state that the income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) of Section 9 of the Act and shall be included in his total income, whether or not,

- (a) the non-resident has a residence or place of business or business connection in India; or
- (b) the non-resident has rendered services in India.

- ***Ashapura Minichem Ltd. v. ADIT (131 TTJ 291) (Mum ITAT)***

In this case, the taxpayer, an Indian company, entered into an agreement with the Chinese company for availing bauxite testing services in the Chinese company's laboratories and for preparation of test reports, which was to be used by the taxpayer to define the process parameters for a consideration of USD 1 million.

The taxpayer contended that since no part of the testing services were rendered in India by the Chinese company; there was no tax liability in India. The taxpayer after relying on the decision of the Supreme Court and Bombay High Court in the case of *Ishikawajima Harima Heavy Industries Ltd. (288 ITR 408)* and *Clifford Chance (318 ITR 237)* respectively, held that provisions of section 9(1)(vii) of the Act would be attracted only if the services were rendered as well as utilised in India.

The Tribunal observed that the decisions referred by the taxpayer in the cases of *Clifford Chance and Ishikawajima Harima Heavy Industries Ltd.* no longer holds good in view of the retrospective amendment to section 9 by the Finance Act, 2010. Accordingly, now it is not necessary that in order to attract taxability in India, the services must also be rendered in India. Thus, as the law stands now, utilisation of services in India is enough to warrant the taxability of these services in India. Accordingly, the amendment in the statute has virtually negated the judicial precedents supporting the proposition that the rendition of services in India is a pre-requisite for the taxability of these services in India.

In light of above, the Tribunal has held that the payments made to the Chinese company towards testing charges were in the nature of FTS under Section 9(1)(vii) of the Act as well as under article 12 of the DTAA entered between India and China, even if the services are rendered outside India. Accordingly, the taxpayer was liable to withheld tax while making payments to Chinese company.

- ***Linklaters LLP v. ITO (132 TTJ 20) (Mum ITAT)***

Recently, the Mumbai bench of the Tribunal in the case of Linklaters LLP dealt with the taxability of the offshore services rendered for Indian projects.

In this case, as well, the Tribunal observed that in view of the retrospective amendment by the Finance Act, 2010 to Section 9(1)(vii) of the Act, the decision of the Bombay High Court in case of Clifford Chance (supra) no longer comes to the rescue of the taxpayer. As long as the services are utilised in India, the income is deemed to arise in India irrespective of the fact that services are rendered outside India. Therefore, entire fees for professional services earned by the taxpayer in connection with the projects in India are taxable in India under the Act.

- ***CIT v. Aktiengesellschaft Kuhnle Kopp by BHEL [2002] 125 Taxman 928 (Mad.)***

The taxpayer company, a resident of West Germany, entered into a collaboration agreement with BHEL, an Indian company, to receive three kinds of payments, viz., royalty, fees for sending technicians to India ('technician fees') and special engineering fees for a particular item of work done ('Special Fees').

The Tribunal held that the technician fees were not taxable in India. Special fees were not taxable in India because (i) the income did not accrue in

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India as the entire work was done in Germany (ii) the income arose under a pre-1976 agreement (iii) it was exempt from India Income-tax under the treaty. Royalty did not accrue or arise in India and was hence not taxable in India.

The Madras High Court held that all the three sums were not liable to tax in India. The High Court observed that:

- As regards Technician Fees, the Tribunal had considered the same questions in its earlier orders for some of the assessment years in question. The tax authorities had neither challenged this order nor brought any material on record before the High Court to show that this order of the Tribunal had not become final. Therefore, the Tribunal was correct in holding the Technician Fees to be not taxable in India.
- Special Fees were not taxable in India as they were paid lump sum under pre-1976 agreement; and
- Royalty on export sales was not taxable in India under Section 9(1)(vi) of the Act. Royalty was paid out of export sales and hence had a source outside India. Thus, though paid by a resident, the royalty could not be deemed to accrue or arise in India.
- ***ACIT v. King Taudevin & Gregson Ltd. [2002] 80 ITD 281 (Bang.)***

The taxpayer, a UK resident company, entered into a contract with an Indian company undertaking to supply engineering designs and drawings and some equipments required for modernising and upgrading the regenerating furnace of the Indian company. The foreign company also agreed to undertake supervision, erection and commissioning of the machinery by deputing its own personnel.

The Indian company remitted the necessary amount towards the import of designs and drawings and for payment of the fees for personnel deputed by the UK Company, after obtaining the necessary approval from the Government of India.

For the assessment years 1987-88 and 1988-89, the Indian company filed a 'nil' return of income as an agent of the UK Company. However, the AO treated the consideration received by the UK company as 'royalty income' and subjected it to tax on the ground that the income had accrued in India.

The CIT(A) set aside the AO's order holding that the payment received by the UK company did not constitute royalty under Section 9(1)(vi) of the Act.

The Tribunal affirmed the CIT(A)'s order on the following grounds:

- A careful scrutiny of the records revealed that the entire service for the designs and drawings was performed at United Kingdom and that no part of services for preparing the designs and drawings was performed in India.
- The said contract revealed that some of the equipments required for modification of the furnace along with the designs and drawings required for modification and execution of the project were imported by the Indian company.
- In view of the decisions of *Scientific Engg. House (P.) Ltd. V. CIT [1986] 157 ITR 86* and *CIT v. Elecon Engg. Co. Ltd. [1987] 166 ITR 66* it could be said that what was received by the Company were capital assets and the remittance to the UK Company was towards payment of the purchase price of the capital goods imported.
- Since all the drawings and designs were made in the United Kingdom and the Indian company only acquired the right to use such drawings and designs for a specified purpose, there was no accrual of income to the UK Company in India.

In view of the above, it could be concluded that the amount received by the UK Company was a capital receipt and not a revenue receipt as held by the AO and hence there was no justification for bringing to tax the payments so made to the UK Company.

• ***CIT v. Mitsui Engg. & Ship Building [2002] 123 Taxman 182 (Del.)***

By virtue of an agreement between the non-resident taxpayer and the Indian party, the taxpayer transferred designs together with engineering, manufacturing, shop testing, packing up to FOB port of embarkation for a composite consideration of Rs. 4,74,000.

The AO brought such transfer of designs within the purview of the term 'royalty' as defined in Explanation 2 to Section 9(1)(vi) of the Act. He accordingly, apportioned the composite consideration and taxed the income arising from such transfer in the hands of the taxpayer. The CIT(A) reversed the order of the AO.

The Tribunal confirmed the order of the CIT(A) and held that it was not possible to apportion the consideration for designs on the one part and engineering, manufacturing, shop testing, packing up to FOB port of

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embarkation on the other. Therefore, the transfer of designs, if any, vis-à-vis other would not come within the definition of 'royalty'.

On a reference, the High Court affirmed the order of the Tribunal. In support of this proposition, reference was made to the Madras High Court's decision in *CIT v. Neyveli Lignite Corpn. Ltd.* [2000] 243 ITR 459 (Mad.).

- ***Hindalco Industries Ltd v Income tax Officer [2004] 91 ITD 64 (Mum)***

The taxpayer, a company, had obtained a techno economic feasibility report from a US company for setting up a steel plant in India and treated the consideration paid for such report as FTS and deducted tax thereon at the rate of 20 per cent. After a lapse of about one and a half year, the Company desired to get the report updated. The US Company would update the report outside India for an agreed consideration. To enable remittance the RBI imposed a pre-condition for depositing advance Tax Deducted at Source (TDS).

The company approached the AO for issuing a no objection certificate without deduction of tax on the ground that the consideration payable to the US Company for updation of the report was for services rendered outside India.

The AO directed the company to deduct tax at the rate of 20 per cent the rate at which the company had deducted tax on remitting the consideration for the earlier report. The CIT(A) upheld the AO's order holding that the situs of the services had nothing to do with taxability of FTS.

The company preferred an appeal to the Mumbai Tribunal. It contended before the Tribunal that business included technical services. Section 9(1)(vii) of the Act had therefore to be interpreted as a part of Section 9(1)(i) of the Act. The consideration payable to the US Company would be taxable in India as FTS only if the US Company had a business connection in India.

According to the company, Section 9(1)(i) of the Act dealing *inter alia* with business connection and Section 9(1)(vii) of the Act dealing with fees for technical services were not independent of each other, as FTS had not been excluded from Section 9(1)(i) of the Act. Further Section 9(1)(vii) of the Act was inserted to define FTS.

The company further contended that the fees for technical services would not be taxable in India if the services were not actually utilized by the resident taxpayers. It relied on the decision of the Supreme Court in the case of *Federation of A P Chamber of Commerce & Industry v State of Andhra*

Pradesh [2001] 247 ITR 36 wherein the expression “is used” has been considered and held that the expression implied actual user and not merely ‘meant for utilisation’.

The Mumbai Bench of the Tribunal held that the company was liable to deduct tax at the rate of 20 per cent on the consideration payable to the US Company treating it to be FTS.

The Tribunal observed that the various categories of income enumerated in Section 9 of the Act, which would be deemed to accrue/arise in India were independent of each other and did not draw any support for their taxation on the other categories of income specified in the section. The Tribunal observed that royalty/FTS were not taxable prior to the Finance Act, 1976 and therefore their taxability was provided for by the insertion of Section 9(1)(vi) and Section 9(1)(vii) in the Acts by the Finance Act, 1976.

The Tribunal observed that Section 9(1)(vii) of the Act was a specific provision dealing with FTS and therefore the general provisions of Section 9(1)(i) of the Act would not apply to Section 9(1)(vii) of the Act.

The Tribunal relied on the decision of the Madras High Court in the case of *CIT v Copes Vikas Inc [1987] 167 ITR 884* wherein it was held that the income by way of FTS whether arising out of business connection or not would have to be treated as falling under Section 9(1)(vii) of the Act and not under Section 9(1)(i) of the Act.

As regards the contention of the services not actually being utilized by the company, the Tribunal observed that under Section 9(1)(vii)(b) of the Act FTS would not be taxable in India if the utilization of the services by the resident taxpayers were for their business carried outside India. If a resident taxpayer has paid FTS outside India for services to be utilized in India then the fees for such technical services would be taxable in India.

The Tribunal held that the company paid consideration for services to be utilized by it in India. The place from where the services were rendered was irrelevant. The consideration paid for the updated report would be FTS, which was deemed to accrue or arise in India and hence would be taxable in India.

- ***SET Satellite (Singapore) Pte Ltd v. ADIT (132 TTJ 459) (Mum ITAT)***

The taxpayer, a tax resident of Singapore, entered into an agreement with GCC, which was also a tax resident of Singapore. Under the agreement, GCC granted the taxpayer rights to broadcast cricket matches in licensed

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territories, which included India. It earned revenue from India from advertisements, which were telecasted on SET Satellite channel. Further, the taxpayer also earned revenues from subscription income collected from cable operators mainly in India. Set India (a group company) was doing marketing activity of the taxpayer in India and therefore, the taxpayer had an Agency PE India in the form of Set India.

The taxpayer contended that the liability for the payment was incurred by the taxpayer for its broadcasting operations in Singapore and had no connection with the marketing activities carried through its PE in India. Therefore, the liability to pay was not incurred in connection with such PE. The financial burden of the payment for live cricket rights was borne by taxpayer's head office in Singapore and not by its agency PE in India.

The AO held that, payments made by the taxpayer to GCC for transfer of telecasting rights were in the nature of Royalty and such payments were deemed to accrue or arise in India under Section 9(1)(vi)(c) of the Act.

The Tribunal held as under:

- Based on Paragraphs 26 and 27 of the OECD Commentary on Article 11, it is evident that for royalties to arise in India, an existence of an economic link between the liability for payment of royalties and PE is necessary.
- In the present case, there was no economic link between the payment of royalties and the PE of the taxpayer in India. The economic link was entirely with the taxpayer's head office in Singapore and therefore, the payments to GCC cannot be said to have been incurred "in connection" with the taxpayer's PE in India.
- The PE in India was not involved in any way with the acquisition of the right to broadcast the cricket matches, nor did the PE bear the cost of payments to GCC. The taxpayer has also not recovered any amount from its PE and therefore, the payments to GCC cannot be said to have been "borne by" the taxpayer's PE in India.

In light of the above, the Tribunal held that, since the liability to pay royalty was not incurred in connection with the PE and was not borne by the PE of the taxpayer in India, royalty did not arise in India as per part two of Article 12(7) of the DTAA.

- **DDIT v. Savvis Communication Corporation [I.T.A. No. 7340/Mum / 2012, Assessment years: 2009-10]**

The taxpayer is a U.S.-based company, engaged in the business of providing information technology solutions, including, web hosting services. During the relevant financial period, the taxpayer earned income from the provision of managed hosting services to some Indian entities. The taxpayer claimed that income is not taxable in India as Fees for Included Services (FIS) under Article 12 of the tax treaty, and it could also not be taxed under Article 7, as the taxpayer did not have any PE in India as per Article 5 of the tax treaty.

The AO was of the view that income received by the taxpayer was for granting the right to use the scientific equipment which was taxable in India under clause (va) of Explanation 2 to Section 9(1)(vi) of the Act as well as under Article 12(3 (b) of the tax treaty.

The CIT(A) following decisions of coordinate benches of this Tribunal held that providing web hosting services, with all backup, maintenance, security and uninterrupted services does not amount to royalty under the provisions of the Act or the tax treaty.

Tribunal's ruling

The use of a scientific equipment by the taxpayer, in the course of giving a service to the customer, is something very distinct from allowing the customer to use a scientific equipment.

The true test is in finding out the answer to the fundamental question- is it the consideration for the rendition of services, even though involving the use of scientific equipment, or is it the consideration for use of equipment simplicitor by the taxpayer? In the former case, the consideration is not taxable, whereas, in the latter case, the consideration is taxable.

In the case of Kotak Mahindra Primus Ltd.⁹, a coordinate bench, dealt with a situation in which the mainframe computer and the specialized software was used for rendering data processing services to an Indian entity. In that case, it was observed that no part of the payment can be said to be for the use of specialized software on which data is processed or for the use of mainframe computer because the Indian company does not have any independent right to use the computer or even physical access to the mainframe computer, so as to use the mainframe computer or the specialized software.

⁹ Kotak Mahindra Primus Ltd v. DDIT [2007] 11 SOT 578 (Bom)

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Payment cannot be said to be the consideration for use of scientific equipment when the person making the payment does not have an independent right to use such an equipment and physical access to it.

In the present case, the taxpayer is providing web-hosting service, though with the help of sophisticated scientific equipment, in the virtual world. The scientific equipment used by the assessee enable rendition of such a service, and such use, which is not even by the Indian entity, is not an end in itself.

Accordingly, even though the services rendered by the taxpayer to the Indian entities may involve use of certain scientific equipment, the receipts by the taxpayer cannot be treated as 'consideration for the use of, or right to use of, scientific equipment,' which is a sine qua non for taxability under section 9(1)(vi) of the Act. Therefore, such payment was not taxable as royalty.

Please refer to the synopsis for the following decisions in relation to software taxability:

CIT v. Samsung Electronics Co Ltd and others [2011-TII-43-HC-KAR-INTL]

CIT v. Lucent Technologies (ITA No. 168 of 2004 and ITA No. 170 of 2004)

CIT v. Synopsys International Old Ltd [2012] 28 taxmann.com 162 (Kar)

CSC Technology Singapore Pte Ltd v. ADIT [2012] 50 SOT 399 (Del)

Accclerys K K [AAR No 989 of 2010, dated 27 February 2012]

Citrix Systems Asia Pacific Pty Limited v. DIT [2012] 343 ITR 1 (AAR)

Organisation Development Pte Ltd v. DDIT [2012] 50 SOT 421 (Chen)

DIT v. Nokia Networks OY [2012] 253 CTR 417 (Del)

DIT v. Infracsoft Ltd. (ITA No. 1034/2009) [2013] 39 taxmann.com 88 (Del)

ADIT v. Antwerp Diamond Bank NV [2014] 65 SOT 23 (Mum)

SkillSoft Ireland Limited [2015] 376 ITR 371 (AAR)

Cincom System Inc. v. DDIT [ITA No. 952/Del/2006, AY: 2002-03] (Del)

Retrospective amendment – Finance Act 2012

The term "royalty" has been defined in Explanation 2 of Section 9(1)(vi) of the Act, which means consideration received or receivable for transfer of all or any right in respect of certain rights, property or information. In order to dispel the doubts arisen from some judicial decisions, whether consideration for use of computer software is royalty or not, the provisions of Section 9(1)(vi) of the Act were amended by the Finance Act, 2012.

Section 9(1)(vi) of the Act was amended to clarify that the consideration for use or right to use of computer software is royalty by clarifying that transfer of all or any rights in respect of any right, property or information as mentioned in Explanation 2, includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Further, section 9(1)(vi) of the Act was amended to clarify that 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.

The scope of Royalty income, including the abovementioned computer software, for non-residents deemed to accrue or arise in India and taxable on gross basis is expanded retrospectively, by the Finance Act, 2012, from 1 June 1976.

Scenario after such retrospective amendment

Tax provisions re-characterised all payments made for computer software to bring them within the ambit of Royalty and thus subject these to source rule taxation in India. However, taxpayers who are residents of the countries having DTAA with India can be protected to the extent the beneficial provisions exist in such DTAAs.

Case laws after amendment

- **Cincom System Inc. v. DDIT [ITA No. 952/Del/2006, AY: 2002-03] (Del)**

The taxpayer is a foreign company engaged in the business of providing software solution including creating personalised document, management of solutions, etc. The taxpayer entered into the 'Communication Agreement' with Cincom Systems (India) Pvt. Ltd. wherein it was agreed that the taxpayer shall provide access to Cincom Systems (India) Pvt. Ltd. to the internet and other email and networking facilities along with other group concern. In consideration of providing these services, the taxpayer was paid a certain sum. For the AY 2002-03, the taxpayer company offered such amount as FIS. However, before the CIT(A), the taxpayer contended that the amount was not taxable in India. The

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CIT(A) held that the payment was not in the nature of FIS, however, held that it was in the nature of royalty.

The Tribunal observed that the AAR in the case of *Abc* [1999] 238 ITR 296 (AAR) held that the definition of the expression 'royalty' under Section 9(1)(vi) of the Act read with clause (vi) of the Explanation includes rendering of any services in connection with any activities for the use of any patent, invention, secret formula or process, etc. In the instant case, the concept of 'source' against 'residence' becomes more significant as the issue relates to cyberspace activities. The transmission of information was through encryption as the data relates to clients and strict confidentiality was observed. It was for the downloading of the software that the royalty is paid. In this context, the source rule becomes relevant which requires that royalty is sourced in the state of the payer. According to the agreement between the American company and the Indian company, the facilities were to be accessed only by the Indian company. The consideration payable was for the specific programme through which the Indian company was able to cater to the needs of the group companies located in Japan and other places. The transaction would be related to a 'scientific work' and would partake the character of intellectual property and therefore, in the character of royalty. The software was customised and a secret. From the facilities provided by the American company to the Indian company, which were of the nature of online, analytical data procession, it would be clear that the payment was received as 'consideration for the use of, or the right to use design or model, plan, secret formula or process'. The use by the Indian company of the CPU and the consolidated data network of the taxpayer was not merely 'use of or the right to use any industrial, commercial or scientific equipment' as envisaged in Article 12(3)(b) of the tax treaty but more than that.

It was the use of embedded secret software (an encryption product) developed by the American company for the purpose of processing raw data transmitted by the Indian company, which would fall within the ambit of Article 12(3)(a) of the tax treaty. The reliance placed by the taxpayer on the decision of the Delhi High Court in the case of *Asia Satellite Telecommunication Co. Ltd. v. DIT* [2011] 332 ITR 340 (Del) is totally misplaced. Accordingly, the ratio of the ruling of AAR in the case of *Abc* was applicable in the present case and the consideration paid was in the nature of royalty within the meaning of Article 12(3) of the tax treaty.

Not taxable under the tax treaties even after retrospective amendments

• **DIT v. Nokia Networks OY [2012] 253 CTR 417 (Del)**

The taxpayer, a tax resident of Finland, supplied GSM equipment comprising both hardware and software to Indian telecom operators under independent buyer-seller agreements. The installation activities were undertaken by the wholly owned subsidiary of the taxpayer, Nokia India Private Limited (NIPL) under independent contracts with the Indian telecom operators.

The issue for consideration before the Delhi High Court was whether the consideration received by the taxpayer for the supply of hardware and software would be chargeable to tax in India under the Act and the India-Finland Tax Treaty.

Based on the facts of the case, the Delhi High Court, inter alia, observed and held as follows:

Whether payments for supply of equipment are taxable

In a transaction relating to the sale of goods, the relevant factor would be as to where the property in the goods passes.

Even in the case of one composite contract, offshore supply is to be segregated from installation.

Relying on the decision of the Supreme Court in the case of Ishikawajima-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC), the High Court concluded that where the property in goods passed to the buyer outside India (i.e. on the high seas), the equipment was manufactured outside India, and the sale had taken place outside India, the income from the supply of equipment would not be taxable in the hands of the taxpayer in India.

Whether payments for software constitute royalty

The language of the tax treaty differs from the language in the amended section 9(1)(vi) of the Act.

The Bombay High Court in the case of CIT v. Siemens Aktiengesellschaft [2009] 310 ITR 320 (Bom) has held that the amendments in the Act cannot be read into the treaty.

In its earlier decision in the case of DIT v. Ericsson A.B. [2012] 343 ITR 370 (Delhi), which had a similar fact pattern as that of the taxpayer, it was held that a copyrighted article does not fall within the purview of 'royalty'.

Accordingly, the payment for software was held to be not taxable as 'royalty' in India.

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- **DIT v. Infrasoftware Ltd. (ITA No. 1034/2009) [2013] 39 taxmann.com 88 (Del)**

The taxpayer is an international software marketing and development company. It is engaged in the business of developing and manufacturing civil engineering software. The taxpayer had opened a branch office in India. The branch in India imports the package in the form of floppy disks or CDs depending on the requirements of their customers. The system was then delivered to a client/customer. The delivery of the system entails installation of the system on the computers of the customers and training of the customers for operation of the system. The branch office further undertakes the responsibility of updation and operational training apart from providing support for solving any software issues.

During the year under consideration, the customised softwares were licensed to the Indian customers and the branch office of the taxpayer in India performed services involving interface to peripheral installation and training. The AO taxed the receipts on grant of licence for the use of software as 'royalty' as per Article 12 of the tax treaty. Further CIT(A) held that the amount received by the taxpayer from its Indian customers under software licence agreement was in the nature of royalty and it was chargeable to tax in India as per Explanation 2 to Section 9(1)(vi) of the Act read with Article 12 of the tax treaty.

The Tribunal held that the amount received by the taxpayer under the licence agreement for allowing the use of the software was not royalty either under the Act or under the tax treaty. Aggrieved by this order the tax department filed an appeal before the High Court.

The High Court held as follows:

- The High Court observed that as per the Licensing Agreement the license was non-exclusive, non-transferable and the software has to be used in accordance with the agreement. Only one copy of the software was being supplied for each site. The licensee was permitted to make only one copy of the software and associated support information and that also for backup purposes. It was also stipulated that the copy so made shall include Infrasoftware's copyright and other proprietary notices. All copies of the Software were the exclusive property of Infrasoftware.
- It was observed that a non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an

authority to enjoy any or all of the enumerated rights ingrained in Article 12 of the tax treaty. Where the purpose of the licence or the transaction was only to restrict use of the copyrighted product for internal business purpose, it would not be legally correct to state that the copyright itself or right to use copyright has been transferred to any extent.

- Distinction has to be made between the acquisition of a 'copyright right' and a 'copyrighted article'. Copyright is distinct from the material object, copyrighted. Copyright is an intangible incorporeal right in the nature of a privilege, quite independent of any material substance, such as a manuscript. Copyright or even right to use copyright is distinguishable from sale consideration paid for 'copyrighted' article. This sale consideration is for purchase of goods and is not royalty.
- Further intellectual property, once it is put on to a media, whether it be in the form of books or canvas (In case of painting) or computer discs or cassettes, and marketed would become 'goods'. There is no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer.
- In view of above, the High court held that there was no transfer of any right in respect of copyright by the taxpayer and it was a case of mere transfer of a copyrighted article. The payment is for a copyrighted article, represents the purchase price of an article, and cannot be considered as royalty.
- The High Court has not examined the effect of the retrospective amendment to Section 9 (1)(vi) of the Act and also whether the amount received for use of software would be royalty in terms thereof as the taxpayer was covered by the tax treaty, the provisions of which were more beneficial.
- **Bharti Airtel Limited v. ITO (TDS) [ITA No. 3593 of 2012] [2016] 67 taxmann.com 223 (Del)**

The taxpayer is a global telecommunication company having operations in several countries including India. The taxpayer, as part of its international long distance (ILD) telecom services business, is responsible for providing

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services to its subscribers in respect of calls originated/terminated outside India. Thus, for providing ILD services, the taxpayer is required to obtain services of the FTO for the provision of carriage connectivity services over the last leg by the communication channel. The taxpayer entered into an agreement with an overseas network corporate to connect the call over the network. The taxpayer provides seamless end-to-end connectivity to the subscribers and the entire revenue from services is paid by the subscribers to the taxpayer. The taxpayer is in turn billed by the FTO in the form of IUC. The AO held that IUC paid by the taxpayer to the FTO, in the course of carrying out its business as an ILD service provider are in the nature of FTS under Section 9(1)(vii) of the Act, or in the alternative, in the nature of royalty under Section 9(1)(vi) of the Act. Accordingly, the income from IUC is deemed to accrue or arise in India in the case of an FTO. The AO levied a tax at a higher rate of 20 per cent on the gross amount of payment made to the FTO for all the years under consideration by applying the provisions of Section 206AA of the Act.

The Tribunal's ruling

Payment of IUC to FTO is not taxable as royalty under the Act

The term 'process' used in the Explanation 2 to Section 9(1)(vi) of the Act in the definition of 'royalty' does not imply any 'process' which is publicly available. The words, which surround the word 'process' in clauses (i) to (iii) of Explanation 2 to Section 9(1)(vi) of the Act refer to various species of IPs such as patent, invention, model, design, formula, trade mark, etc. Thus, the word 'process' must also refer to a species of IP applying the rule of 'ejusdem generis' or 'noscitur a sociis' as held by the Supreme Court in the case of Bharti Cellular Ltd.

Based on the above and certain decisions, it was held that the term 'royalty' connotes exclusivity and the exclusive right in relation to the thing (be it physical or IP) for which royalty is paid should be with the grantor of that right. There is a clear distinction between a 'process' and the physical equipments and resources deployed in the execution of a 'process'. While the former is an intangible asset, the latter is tangible and has a physical existence.

The owner of the 'process' might grant the 'use' or 'right to sue' to different persons at the same time, but the exclusivity of the ownership should be with the grantor.

If the IP is used by the owner himself and he bears the risk of exploitation or liabilities for the use, then as the owner makes own entrepreneurial use of the IP the income would fall under the scope of 'business income' and not 'royalty'. The 'royalty' in respect of the use of a 'process' would imply that the grantor of the right has an exclusive right over such 'process' and allows the 'use' thereof to the grantee in return for a 'royalty'. It is necessary that grantee must 'use' the 'process' on its own and bear the risk of exploitation.

The 'process' of running the network in the cases of all the telecom operators is essentially the same and they do not have any exclusive right over such 'process' so as to be in a position to charge a 'royalty'. For allowing the use of such process, the term 'use' in the context of royalty connotes use by the grantee and not by the grantor.

Explanation 6 to Section 9(1)(vi) of the Act, does not eliminate the requirement of successful exclusivity of the right in respect of such process being with the person claiming 'royalty' for granting its usage to a third party. None of the FTOs has any exclusive ownership or rights in respect of such process, and hence, the payment cannot be considered as royalty.

Explanation 5 to Section 9(1)(vi) of the Act applies only in case of royalty falling within the ambit of Explanation 2 of Section 9(1)(vi) of the Act. When a process is widely available in the public domain and is not exclusively owned by anyone, then it cannot constitute an item of IP for the purpose of charge of 'royalty' under clauses (i), (ii) and (iii) of Explanation 2 to Section 9(1)(vi) of the Act. Hence, Explanation 5 has no effect in the instant case.

Applying the decision of the jurisdictional High Court, it was held that the payment cannot be termed as royalty under Section 9(1)(vi) of the Act.

Payment of IUC to FTO is not taxable as royalty under the tax treaties

The definition of 'royalty' provided in the relevant tax treaties use the expression 'secret formula or process' and it is separated by a comma before and after the expression. This implies that 'formula/process' is a part of the same group and the adjective 'secret' governs both. Only payments received as consideration for the 'use of', or 'the right to use' is necessary for the payment to be termed as royalty. This is much narrower to the definition of 'royalty' under the Act.

Thus, under the treaties, in order to constitute royalty for use of or the right to use of a process, the process has to be 'secret'. In the case of the telecom industry, however, telecommunication services are rendered through standard facilities and no 'secret process' is involved.

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There is no 'use of' or 'right to use' of any process in the present case and hence, even under the tax treaties, the payment cannot be termed as royalty. Based on various decisions, it was held that the payment was not 'royalty' under the tax treaties.

Position subsequent to the retrospective amendment by the Finance Act, 2012

There would not be any change in the above position, even subsequent to the retrospective amendments introduced by way of Explanation 5 and 6 to Section 9(1)(vi) of the Act, since changes in the Act cannot be read into the tax treaties as long as there is no change in the tax treaties.

Following the jurisdictional High Court decisions as well as decisions of other Courts, it was held that the amendments introduced by the Finance Act 2012 cannot be read into the tax treaties.

- **DIT v. New Skies Satellite BV [2016] 68 taxmann.com 8 (Del)**

Shin Satellite Public Co. Ltd. (taxpayer) is a company incorporated in Thailand, engaged in the business of providing digital broadcasting services as well as consultancy services to its customers who consist of both Indian residents and non-residents. The taxpayer provides these services through its satellite whose footprint covers a large geographical area, including India. New Skies Satellite B.V (taxpayer) is a company incorporated in Netherlands, engaged in providing digital broadcasting services. Both the taxpayers in the present case derive income from the 'lease of transponders' of their respective satellites. The taxpayers had filed nil returns for the relevant assessment years. The AO held that the income was taxable under Section 9(1)(vi) of the Act as well as under Article 12 of the India-Thailand/India-Netherlands tax treaties. The Tribunal relied on the decision of the Delhi High Court in the case of Asia Satellite Telecommunication Company Ltd. where it was held that the receipts earned from providing data transmission services through the provision of space segment capacity on satellites do not constitute royalty within the meaning of Section 9(1)(vi) of the Act. Subsequently the Finance Act, 2012 amended the definition of royalty under Section 9(1)(vi) of the Act and inserted Explanation 4, 5, and 6. The inclusion of these explanations have attempted to undo the implications of decision in the case of Asia Satellite.

The issue before the Delhi High Court was whether the income derived by the taxpayers through data transmission services was taxable as royalty

under Section 9(1)(vi) of the Act as well as Article 12 of the tax treaty. Whether the amended definition of royalty under the Act can be used to interpret the definition of royalty in the tax treaties.

High Court's ruling

Taxability under the Act

The legislature is competent to amend a provision that operates retrospectively or prospectively. Nonetheless, when disputes as to their applicability arise in court, it is the actual substance of the amendment that determines its ultimate operation and not the bare language in which such amendment is couched. The Delhi High Court in the case of TV Today Network Limited held in favour of the tax department, and observed that as far as domestic taxability of the income from data transmission services is concerned, the Finance Act 2012 mandates it to be as such. Therefore, income from data transmission services is royalty.

Explanations 4 to 6 are designed as clarificatory amendments. Unarguably they have all the apparent characteristics of one. The words 'for the removal of doubts, it is hereby clarified...includes and has always included' qualify the interpretation in Explanation 5. In Explanation 6, the same words have been modified and they state 'includes and has always deemed to have always included'. This is the standard language used to communicate an intended retrospective effect. The circumstances in this case could very well go to show that the amendment was no more than an exercise in undoing an interpretation of the court, which held income from data transmission services as non-taxable under Section 9(1)(vi) of the Act.

The High Court is disinclined to conclusively determine or record a finding as to whether the amendment to Section 9(1)(vi) of the Act is indeed merely clarificatory as the tax department suggests it is, or prospective, given what its nature may truly be. The issue of taxability of the income of the taxpayer in this case may be resolved without redressal of the above question purely because the taxpayer has not pressed this line of arguments before the court and instead stated that even if it were to be assumed that the contention of the tax department is correct, the ultimate taxability of this income shall rest on the interpretation of the terms of the tax treaties. The High court therefore proceeds with the assumption that the amendment is retrospective and the income is taxable under the Act.

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Taxability under the tax treaty

No amendment to the Act, whether retrospective or prospective can be read in a manner to extend its operation to the terms of an international treaty. Clarificatory or declaratory amendment, which may seek to overcome an unwelcome judicial interpretation of law, cannot be allowed to have the same retroactive effect on an international instrument effected between two sovereign states prior to such amendment.

Article 39 of the Vienna Convention on the Law of Treaties, 1969 (VCLT) states the general rule regarding the amendment of treaties and provides that a treaty may be amended by an agreement between the parties. Unilateral amendments to treaties are therefore categorically prohibited. As held in the case of *Azadi Bachao Andolan*, treaties are creations of a different process subject to negotiations by sovereign nations. The Madras High Court in the case of *VR. S.R.M. Firms Ors.* held that 'tax treaties are considered to be a mini legislation containing in themselves all the relevant aspects or features which are at variance with the general taxation laws of the respective countries'. The Parliament is simply not equipped with the power to, through domestic law, change the terms of a treaty. A treaty is not drafted by the Parliament; it is an act of the executive.

The decision in the case of *Asia Satellite* takes note of the OECD Commentary and Klaus Vogel on tax treaties, to show that the process must in fact be secret and that specifically, income from data transmission services do not partake of the nature of royalty. India's change in position to the OECD Commentary cannot influence the interpretation of the words defining royalty as they stand today. The only manner in which such change in position can be relevant is if such change is incorporated into the tax treaty itself and not otherwise. Mere amendment to Section 9(1)(vi) of the Act cannot result in a change. It is imperative that such amendment is brought about in the tax treaty as well.

Since the Finance Act, 2012 will not affect Article 12 of the tax treaties, it would follow that the first determinative interpretation given to the word 'royalty' in *Asia Satellite*, when the definitions were in fact *pari materia* (in the absence of any contouring explanations), will continue to hold the field for the purpose of assessment years preceding the Finance Act, 2012 and in all cases which involve a tax treaty, unless the said tax treaties are amended jointly by both parties to incorporate income from data transmission services as partaking of the nature of royalty, or amend the definition in a manner so that such income automatically becomes royalty.

The SLP has been granted against the High Court ruling in **DIT v. New Skies Satellite B. V. [2016] 73 taxmann.com 38 (SC)**.

8.2 E-Commerce transactions

Traditionally determination of profits was relatively simple. Profit could arise either from property or from carrying out of an activity. Profit from property could be said to arise out of tangible and intangible property and profit from carrying out of an activity would include manufacture as well as rendering of a service. Earlier it was easier to say that profit from the property arose where the property is located and profit from activity arose where the service was rendered or from where the manufacturing was done.

However, with increasing use of e-commerce, the internet and rapid universalisation of technology, it may be not possible to draw a line on the place and moment of rendering of the service. The shift from the physical to e-commerce throws up various issues like; is it the location of the supplier or the customer that will determine the taxable point of transaction; does the server constitute a PE, etc. When it comes to e-commerce, the traditional question of where the property is located or pinpointing where the services are rendered is not as easy to answer. The question from where the service is rendered from, has assumed more importance. E-commerce does not recognize jurisdictional boundaries and therefore, the whole mind set on how to approach taxation of goods and services requires a sea change.

The emphasis, as we saw in the earlier Chapters, is on the resident State, which has been given a right to tax the income. However, the source State's right, in respect of income, which arises therein, is also recognized. The rate of tax, as we saw in the case of royalty, interest etc., is a matter of bargain. Even in the case of business, the profits are only taxed if the business is carried on through a PE in the source State. The question is whether these rules are enough to combat e-commerce.

Whether the existing tax laws are sufficient to tackle the challenges thrown up by e-commerce was also the issue before the Task Force appointed for evaluation of e-commerce taxation. The committee concluded that no special rules were required as the existing law was good enough; as e-commerce is carved out of business therefore, the laws for determining business income ought to be good enough to determine taxability of e-commerce income. In fact, even the OECD feels that the existing principles on tax treaties and transfer pricing, with suitable modifications and elaboration, are capable of being applied to e-commerce income.

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The requirements of trade are that there must be a willing buyer and a willing seller for the goods and they should be able to communicate and ultimately deliver the product. In the case of e-commerce, the Internet puts the buyer and seller in contact and allows communication. The delivery is possible only in the case of goods which can be converted into software and delivered over the net e.g. information products. In fact except for physical goods, most items can be delivered for e.g. music can be downloaded from paid sites as well as unpaid sites; this does not require the physical movement of cassettes. In fact, there is a big battle going on between the music companies and the web sites, as the music companies have to come to terms with a drop in their profits on account of the increased use of the Internet. Who is right or wrong is not the point of debate here and that is better left to the Courts but this has thrown up one certain reality that the traditional business will either have to adapt and change fast or see their bottom lines fading. In fact, even despite of change, traditional business cannot expect to earn huge profits as there are now more people sharing the pie.

Everyone talks very highly of e-commerce now let's try and understand what it is.

What is E-commerce?

E-commerce simply put can be online shopping where goods and services are exchanged on the Internet, as against a traditional shopping place, where the delivery and payment can also be completed online. This is direct e-commerce. However, certain goods, which are not capable of delivery on-line like tangible goods are physically delivered. So today, we can order a refrigerator from any part of the world, provided of course that we are willing and able to bear the high import duties, and do not have to depend on the grey market for getting that coveted brand! With more countries entering into Free Trade Agreements with each other, even the import duties may not be such a worrying factor. This shows how much we are moving towards a borderless world and what we could only dream of 10-15 years ago or depend on a benevolent aunt in the USA are now just a click away.

However, there is no formal definition of e-commerce yet. E-commerce has been defined by the OECD to be "commercial transactions, involving both organizations and individuals, that are based upon the processing and transmission of digitalized data, including text, sound, and visual images and that are carried over open networks (like the Internet) or closed networks

(like AOL or Minitel), that have a gateway onto an open network.” E-commerce can be business-to-business, business-to-customer, customer-to-business or customer-to-customer, and would include call centre services as the services are provided from a jurisdiction other than where they are requested. E ticketing of travel, entertainment, E-banking are examples of e-commerce.

The International Fiscal Association (IFA) has in the Report released at the 55th Congress held in October, 2001 defined e-commerce as “commercial transactions in which the order is placed electronically and goods or services are delivered in tangible or electronic form and there is an ongoing commercial relationship.”

E-business involves doing the business through the Internet. Therefore, any traditional businessperson can create its web site and offer customers its goods and services through the net without being physically present in the country. This eliminates the intermediary and allows direct communication and feedback from the customers. The delivery may not be possible on the net for all kinds of goods but the company can provide either home service or put the customers in touch with its logistic manager to figure out the delivery process. Therefore, in many ways, the traditional question of where has the profit-arisen can still be answered depending on where the sale was affected and where the goods were delivered. In case of services, there can be a virtual office and services can be rendered from the State of residence without being physically present in the State where the service is rendered. Does this mean that the source State should lose out on what would have been its rightful share in the income of course, assuming that the service was rendered through a PE or fixed place? Even in the case of a business where there is no physical presence through a PE or a fixed place, can the server or a web site be a PE on the ground that products are marketed and sold through where the server is located? Of course, to determine who owns the server could also pose a problem as most companies, which carry on such business, are multi layered and it is not necessary that the company, which owns the product, also owns the server.

Issues in taxation of E-commerce

The problem with taxation of e-commerce is that there is a danger of it either being taxed in both countries or going untaxed in both. Therefore, it is essential to find a common denominator and arrive at a sharing agreement so that countries do not lose out on revenue. There are enough problems in

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capturing domestic transactions, which are augmented while dealing with cross border transaction as it is not possible to pinpoint the place of business, further it may also be possible that there was value addition in a third country, which may not be possible or may be difficult to pinpoint and can these intermediate points be taxed is an issue? E-commerce does not fit completely into the definition of business, royalty or FTS. It is sometimes argued that the perhaps a substitute has to be found for the concept of PE even for traditional business. However, till that is done the concept of business connection and PE as understood now will have to be applied. However, when you consider the means through which e-commerce is applied it may become difficult to apply the concept of PE. The means may be through the Internet, the web site, or through an Internet Service Provider. As we saw while dealing with royalty, the concept of ownership over intellectual property rights is difficult to establish. Even the e-commerce report was not able to come up with any solution to the problem. However, it has identified areas of problem such as:

- Identity and location of parties;
- Anonymity of transactions and accounts;
- Dis-intermediation;
- Transfer pricing issues;
- Online delivery and net cash;
- Easy access to tax havens and low tax jurisdiction;
- New evasion opportunities;
- Recovery of tax;
- Exchange of information; and
- Tax payer service opportunities.

As we saw earlier in the case of services, with now video and audio conference quality improving it is not necessary for the person to be present in the source State, which may result in the source State losing out on legitimate taxes.

The traditional concept of PE as requiring a physical presence is also being challenged, for e.g. even vending machines may be considered as a PE. In the case of e-commerce, it is argued that the fixed place of business is created in the computer of the person who continuously accesses the web

site and downloads information. The arguments of exclusions from PE i.e. only a means of storage of goods or preparatory services may be extended to e-commerce also, if the general notion of fixed base is to be so extended to e-commerce. There are also many unresolved issues involved viz. what constitutes continuous access of the website? To what extent is any human intervention required in the completely automated process? The Internet Service Providers should not be agents as they service more than one customer and secondly they do not have authority to conclude contracts. There is no clear-cut recognition of whether a web site or a server constitutes a PE. The issue that also arises is on the allocation or the attribution of the income, how is the usage of the people to be calculated considering that these are all global sites and further everyone who visits the website may not complete a sale.

These problems get further magnified when you take the earlier example of music, say one person downloads certain songs makes a cassette out of it and distributes it either free or by private sale; how are such transactions ever going to be captured and even if they are; is it business income or royalty for use of copyright? Or further still if the music is not downloaded and the customer goes to the site each time and listens to the song is there a license fee or a lease charge applicable? If in conventional circumstances all these transactions would have been taxable, why should it be any different in e-commerce? The problem is of tracking the transactions which is a humongous task especially, if the intention is to avoid/evade tax.

As this represents a loss of tax for many countries, they need to come to some consensus on monitoring Internet usage and sharing of information and revenue. In e-commerce the balance of odds are with the Residence State, as the resident will pay tax on global income while the source State loses out on its share. Therefore, all countries, never knowing which way the dice will roll to show them as source or resident State must come together to arrive at a solution. The challenge in e-commerce is to identify means of pinpointing the place; this can be achieved by discussion by and within the trade and the Governments to arrive at an understanding of how the system works and then work backwards to arrive at the solution. In the case of business-to-business transactions, norms on TDS and disallowance of payments without TDS may be enforced as in case of normal payments to non-residents. However, in the case of individuals, it may be impossible to track payments, especially when made electronically. With exchange controls

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norms being liberalized in most countries, there is no control over such payments.

A few case laws, which may be useful

In the case of *TVM Ltd. v. CIT [1997] 237 ITR 230 (AAR)* the non-resident TVM was engaged in the business of development and broadcasting of television programmes and the profits were earned from sale of air time on the TV channel's broadcast in India amongst other countries. The satellite channel was operated from Mauritius. The software was supplied by an Indian company. The issue was whether the profit on sale of airtime was taxable in India and whether the Indian company could be an agent (this decision has been discussed earlier also in the Chapter on PE). The issue was decided on the basis of whether TVM was entitled to the benefits of the DTAA, the AAR held that though the income could be said to arise in India under Section 9 of the Act, it was not taxable in the absence of a PE. Though selling of broadcasting may also be considered an example of e-commerce, the issue was unfortunately not considered by the AAR, though the AAR did say that the *Circular No.742 dated 2 May 1996, which* deemed 10 percent of the profits to be taxable in India of telecasting companies was not correct in the absence of a PE.

Even in the case of *Ericsson Telephone Corporation of India AB v. CIT [1997] 224 ITR 203 (AAR)*, where the issue was on taxability of supply of hardware and software in connection with introduction of cellular system of telecommunications or mobile telephone system and its related services in India, the issue was decided on the conventional modes and whether it constituted e-commerce was not gone into.

In re, P.No.30 of 1999 [1999] 238 ITR 296 (AAR) was a classic example of e-commerce where the applicant was a US company and had a sub-subsiary in India which transmitted the data it obtained from the Indian clients to a Central Processing Unit (CPU) maintained in the USA for processing, which was sent to its client after processing by the US company through it i.e. the Indian company. The CPU was accessed via a Central Data Network (CDN) installed in Hong Kong. The Indian company paid a user fee to the USA Company. The AAR held that the payment was for the use of embedded secret software and online facilities, which meant that payment was for the use of technical know-how, clearly falling under royalty.

In the case of *ITO v. Raj Television Network Ltd. ITA No. 1827 and 1828*

(MDS) the company was in the business of telecasting TV programmes in India and abroad via satellite. It had an agreement with Reuter Television Ltd. (RTV) for transponder services and uplinking for which it made payments. The issue was whether the payment for the transponder service was taxable in India. The Tribunal felt that the transponder fee did not fall under the definition of royalty or FTS either under the Act or under the DTAA. The signal coming from the transponder did not mean that RTV had done anything in India to earn income. Further, in the absence of a PE the income was not taxable in India. A detailed analysis of this decision is given at the end of the Chapter.

In the case of *Skycell Communications Ltd. v. DCIT [2001] 251 ITR 53 (Mad)* it was held that a cellular telephone service provider does not provide a technical service to its subscriber by virtue of the fact that it installs sophisticated instrument to provide connectivity to the users.

In the case of *M/s. Wipro Ltd v. Income-tax Officer ITA Nos. 152 to 154/Bang/2004 dated 30 December 2004 94 ITD 9*, it was held that payments made to a non-resident for electronic access to database for on-line purchase of web-based reports/magazines are not taxable in India. The taxpayer, a company, entered into an agreement with a non-resident research agency based in USA (Gartner) subscribing on an annual and a semi-annual basis to Gartner's periodical publication on business data. The Company made payment of subscription charges/fees to Gartner for accessing data/information available on Gartner's electronic database without withholding any tax from these payments. The Tribunal held that payment for an access to electronic database could not be said to be a consideration 'for use of information concerning industrial, commercial or scientific experience', to fall within the scope of the definition of royalty. The detailed analysis of the decision is given in the Appendices Chapter on Important AARs.

The High-Powered Committee report does try to give the taxability of various payments under the OECD Model, the India - UK DTAA and the India-US DTAA; however, this is only the view of the committee and would require examination on the facts of each case. The Report is published in *251 ITR (St.) [2001] 118*.

Therefore, taxation of e-commerce is one of the many new challenges facing the tax authorities today and how it is dealt with will be an interesting development to watch.

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- **Yahoo India (P.) Ltd. v. DCIT [2011] 11 taxmann.com 431(Mum)**

The taxpayer, a wholly owned subsidiary of Yahoo Inc, USA (Yahoo USA), was engaged in the business of providing consumer services such as search engine, content and information on wide spectrum of topics, e-mail, chat, etc.

During the assessment proceedings, the Assessing Officer (AO) noticed that the taxpayer had made payment to Yahoo Holdings (Hong Kong) Ltd. (Yahoo Hong Kong) for cost of services / research material / advertisement media. Yahoo Hong Kong was engaged in the business of providing internet services, technological tools and marketing solutions for business to the customers in Hong Kong. Further, Yahoo Hong Kong provides banner advertisement and microsite hosting services on the Yahoo Hong Kong Portal. The Department of Tourism of India (DTI) through an advertisement agency Media Turf Worldwide intended to display a banner advertisement on the portal owned by Yahoo Hong Kong. For this purpose, the DTI hired the services of the taxpayer to approach Yahoo Hong Kong to provide uploading and display services for hosting the banner advertisement at Yahoo Hong Kong Portal. Accordingly, the taxpayer entered into a contract with the DTI and hired the services of Yahoo Hong Kong for uploading and display of banner advertisement on its portal. The taxpayer made payment for the services without deduction of tax at source on a view that the services / operations performed by Yahoo Hong Kong were entirely outside India and were not taxable in India. The AO contended that the income attributable to the services claimed to be rendered outside India had accrued in India as per the provisions of Section 9 of the Income-tax Act, 1961 (the Act). Therefore, the taxpayer was required to deduct tax at source before remitting the said amount to Yahoo Hong Kong. Since tax was not deducted, the payment was disallowed by the AO by invoking the provisions of Section 40(a) of the Act. The Commissioner of Income-tax Appeal [CIT(A)] held that irrespective of the definition of 'business connection', once the source of income was established to be in India, the income was deemed to accrue or arise in India for the purpose of Section 9 of the Act. Further, the CIT(A) held that the payment made for the use or right to use any industrial, commercial or scientific equipment was in the nature of royalty and the same was taxable under Section 9(i)(vii) of the Act in the hands of Yahoo Hong Kong.

Tribunal's ruling

The Tribunal relied on the decisions of AAR in the case of Isro Satellite

Centre¹⁰ and in the case of Dell International Services (India) P. Ltd¹¹. In case of Isro Satellite Centre, it was held that by earmarking a space segment capacity of the transponder for use by the taxpayer, the taxpayer did not get possession of the equipment nor did the taxpayer use any equipment of parent company. Therefore, payment made by the taxpayer was not regarded as payment made for the use of equipment.

Further, in case of Dell International Services (India) P. Ltd, it was held that the word 'use' in relation to equipment occurring in clause (iva) of explanation to Section 9(1)(vi) of the Act was not to be understood in the broad sense of availing of the benefit of an equipment. What was contemplated by word 'use' was that the customer came face to face with the equipment, operated it or controlled its function in some manner.

The Tribunal held that the payment made to Yahoo Hong Kong was for services rendered for uploading and display of the banner advertisement of the DIT on its portal. It did not involve use or right to use by the taxpayer of any industrial, commercial or scientific equipment and no such use was actually granted by Yahoo Hong Kong.

The tribunal further observed that the taxpayer had no right to access the portal of Yahoo Hong Kong and there was nothing to show any positive act of utilization or employment of the portal of Yahoo Hong Kong by the taxpayer.

Accordingly, the tribunal held that payment made was not in the nature of royalty but the same was in the nature of business profit and in the absence of any PE of Yahoo Hong Kong in India, it was not chargeable to tax in India.

• **ITO v. Right Florists Pvt. Ltd. (ITA No.1336/Kol/2011)**

The taxpayer, a florist, had made payments in respect of online advertisements to Google and Yahoo without deducting taxes on the basis that since these entities did not have any PE in India, the payment made to them was not taxable in India.

The AO disallowed the payments in the hands of the taxpayer under Section 40(a)(i) of the Act on the basis that tax was required to be deducted from the payments made to Google and Yahoo.

The issue for consideration before the Kolkata Tribunal was whether the payment in respect of online advertising on search engines of Google and Yahoo is taxable in India.

¹⁰ Isro Satellite Centre [2008] 302 ITR 59 (AAR)

¹¹ Dell International Services (India) P. Ltd [2008] 308 ITR 37 (AAR)

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Based on the facts of the case, the Tribunal, inter alia, observed and held as follows:

- A search engine's presence in a location, other than the location of its effective place of management, is only on the internet or by way of its website, which is not a physical form of presence;
- In accordance with the High Power Committee report, so far as the basic rule of PE is concerned, a website per se cannot be a PE under the Act;
- The interpretation of the expression PE, even in the context of tax treaties, does not normally extend to websites unless the servers on which websites are hosted are also located in the same jurisdiction;
- A search engine, which has only its presence through its website, cannot be treated as a PE unless its web servers are also located in the same jurisdiction. As Yahoo and Google's servers are not located in India, its presence in India merely through websites cannot be construed as PE in India;
- The Government of India's reservations on OECD (relating to websites constituting a PE in certain circumstances) does not have an impact in the instant case;
- Relying on the decisions of the Mumbai Tribunal in the case of Pinstorm Technologies Pvt. Ltd. and Yahoo India Pvt. Ltd, the Tribunal held that the payments to Google and Yahoo are not in the nature of 'Royalty';
- As long as there is no human intervention in a technical service, it cannot be treated as a technical service under Section 9(1)(vii) of the Act. As there was no human touch involved in the whole process of the advertising service provided by Google and Yahoo, the payments are not in the nature of 'fees for technical services';

Therefore, the payments were not taxable in India and there was no requirement for the taxpayer to deduct tax at source

- **Pinstorm Technologies Pvt. Ltd. v. ITO [2012] 24 taxmann.com 345 (Mum)**

The taxpayer is a company engaged in the business of digital advertising and internet marketing. It utilises the internet search engine such as Google, Yahoo, etc. to buy space in advertising on the internet on behalf of its clients. The search

engine carries out its programme whereby the taxpayer books certain words called 'key words'. Whenever any person searches through the net for a specific 'key word', the advertisement of the taxpayer or its client is displayed. For example, if the 'key word' 'Hotels in Mumbai' is searched for, the advertisement of 'Taj Hotel' may be displayed among sponsor links on the search engine page.

During the year under consideration, the taxpayer had made a payment to Google Ireland Ltd. (Google Ireland) and claimed that as advertisement expenditure. While making the said payment, no tax was deducted at source by the taxpayer on the ground that the said amount constituted business profits of Google Ireland and since it did not have any PE in India, the amount paid was not chargeable to tax in India.

According to the AO, the services rendered by Google Ireland to the taxpayer were in the nature of technical services and hence the taxpayer was liable to deduct the tax at source from the payment made against the said services. Since no such tax was deducted at source by the taxpayer, the deduction claimed by the taxpayer on account of the advertisement expenditure was disallowed by the AO by invoking the provisions of Section 40(a)(i) of the Act. The CIT(A) held that the payment made by the taxpayer to Google Ireland for the services rendered was in the nature of royalty chargeable to tax in India. Since there was failure on the part of the taxpayer to deduct tax at source, the CIT(A) confirmed the disallowance made by the AO.

Tribunal's ruling

As the issue involved in the present case as well as all the material facts relevant thereto, were similar to the case of Yahoo India (P.) Ltd., the decision rendered by the co-ordinate Bench of this Tribunal in the said case has been followed.

The amount paid by the taxpayer to Google Ireland for the services rendered for uploading and display of banner advertisement on its portal was in the nature of business profit. No tax was deductible at source on such payment since the same was not chargeable to tax in India in absence of any PE of Google Ireland in India. Accordingly, the disallowance made by the AO was deleted.

- **Areva T & D India Limited [2012] 18 taxmann.com 171 (AAR)**

Areva T & D SAS France (Areva France) is engaged in designing, engineering, manufacturing and supply of electric equipments that helps in transmission and distribution of power, commissioning and servicing of transmission and distribution system on turnkey basis. The applicant is a subsidiary of Areva

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France in India. Areva France is proposing to enter into an Information Technology Sharing Services Agreement (ITSA) with the applicant in order to provide support services in the area of information technology.

The support services would be worldwide network for data transfer between all group companies, which will connect to all global applications of Areva France and intranet and internet traffic, messaging system for all e-mail communication between the subsidiaries and vendors, customers, etc.

Support services will be provided across the world from France and the consideration for availing these services will be apportioned to all subsidiaries.

The allocation key for determining the consideration would be based on the service provider's invoices, indirect cost based on IP Bandwidth license user rights and number of users per application for each of its subsidiary. The applicant is of the view that the services rendered by Areva France are merely supportive and coordinated in nature and do not impart any technical knowledge to the applicant.

AAR's ruling

- The AAR observed that the Model Commentary states that a PE may exist if the business of the enterprise is carried on mainly through automatic equipment and the activities of the personnel are restricted to setting up, operating, controlling and maintaining such equipment. Thus, even existence of a computer server amounts to existence of a PE.
- The AAR on a perusal of UN Commentary (2001) observed that the place of business, which includes equipment, should be at the disposal of the foreign enterprise for the purpose of the business activities. Since there is no contractual relation between the applicant and other service provider, all equipment under the ITSA is at the disposal of Areva France.
- Further on a perusal of the book 'The Law and Practice of Tax Treaties: An Indian Perspective' (2008) the AAR held that since the tests of PE are satisfied, whether it is equipment leased or it is owned by the Areva France, will be of no consequence.
- Accordingly, the AAR held that the Areva France has a PE in India. Therefore, the payment by the applicant to the Areva France under the ITSA is to be treated as business income and liable to be taxed as per Article 7 of tax treaty.

Contentious Issues

- Under the ITSA, the Areva France is to provide support services through a central team in the area of information technology to the applicant and to its other subsidiaries in the world. The provision of support services by the Areva France would itself make available, the technical knowledge / experience to the applicant.
- Relying on the decision in the case of Perfetti Van Melle Holding B.V. the AAR held that the technology is made available to the applicant as the information technology provided is applied in running the business of the applicant and the employees of the applicant would get equipped to carry on these systems on their own without reference to the Areva France.
- Therefore, the AAR held that services provided under the ITSA are in the nature of FTS and taxable under the tax treaty as well as under the Act. Further, as the Areva France has a PE in India, the income by way of FTS will be taxed under Section 44DA of the Act. The AAR observed that ITSA states that Areva France has the capacity and the resources to provide and co-ordinate IT Services to the Applicant. The AAR held that the payment was not in the nature of reimbursement.
- **ITO v. Pubmatic India Pvt. Ltd. [2013] 36 taxmann.com 100 (Mum)**

The taxpayer, an Indian company, and its holding company in US, engaged in the business of providing services of internet advertising and marketing services including e-commerce transactions and provision of related technologies, systems, consultancy, devices, etc. When the taxpayer place order to its parent company, the parent company books space on relevant foreign website and then sales space to the taxpayer at cost plus mark-up. The taxpayer in turn sells the said space to its Indian client at cost plus profit.

During the year under consideration, the taxpayer made payment to US Company for purchases of online advertisement space. The taxpayer claimed that the business income of US Company was not taxable in the absence of PE and therefore, withholding of tax was not required on such payment. The AO disallowed the expenditure while computing taxable income of the taxpayer and held that the taxpayer was required to withhold the tax. The CIT(A) deleted the addition by the AO.

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Tribunal's ruling

- On perusal of the arrangement made between the taxpayer and US Company it indicates that neither of the party is doing the business activity on behalf of other. Further, the transactions are independent business transaction wherein the respective margins are recovered from each other. The transaction of payment towards the purchase of space on foreign website by the taxpayer for its client in any case does not constitute a transaction carried out by the taxpayer on behalf of its US Company.
- The taxpayer was doing the business on behalf of its client and offering the income earned from the said business transaction for taxation in India. Therefore, the transaction of purchase of space on foreign website by the taxpayer from US Company cannot be treated as PE.
- Merely because one of the director is common in both the companies does not constitute the taxpayer as PE. Even otherwise, the common director and holding of the company by itself does not constitute either company as a PE of the other as per Article 5(6) of the tax treaty. The similarity of business activity does not, by itself, indicate that the taxpayer is acting or doing business on behalf of its parent company so that it constitute an Agency PE of US Company.
- The record does not indicate that either the taxpayer or US Company is providing the service/goods to the clients of the other party. Therefore, when none of the party is dealing with the clients of the other party then the activity between the taxpayer and US Company are independent business activities. There is no written agreement between the taxpayer and US Company. Though the Transfer Pricing Study specifies an arrangement between the taxpayer and AE, however, that does not mean that the taxpayer having a written agreement.
- When the transactions are claimed to have taken place at ALP, then there is no question of the taxpayer doing the business activity on behalf of US Company. The transaction between the taxpayer and the US Company are independent business between two parties.
- The risk and reward of the business carried out by the taxpayer is born by the taxpayer which indicate that it is the taxpayer who is

answerable to the customers and therefore, the activity of purchase of space on website from the parent company is on principle to principle basis. Thus, purchase of advertisement space on foreign website falls under business income of US Company under the tax treaty. However, in the absence of PE of US Company, the said business profits were not taxable in India. Accordingly, the taxpayer was not required to deduct tax in respect of said amount, which is trading receipt in view of the decision of the Supreme Court in case of GE India Technology Centre Pvt. Ltd.

Summary of findings contained in the OECD report

In view of the importance of the issue and to determine in what circumstances electronic commerce (e-commerce) activities, especially the operation of servers lead to constitution of PE in the jurisdiction of their location, the OECD Committee of Fiscal Affairs has inserted its position to the existing OECD Model Commentary on Article 5 on the treatment of e-commerce transactions, when web sites and servers constitute PE.

The key observations of the OECD are summarized below:

Whether server / web-site constitute PE?

- A distinction needs to be made between computer equipment, which may be set up at a location to constitute a PE under certain circumstances, and the data and software, which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore, does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.
- The fees paid to the Internet Service Providers ('ISP') under the arrangements of hosting the web site on servers may be based on the amount of disk space used to store the software and data required by the web site. These contracts typically do not result in the server and its location being at the disposal of the enterprise,

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even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location.

- In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a PE of the enterprise if the other requirements of the Article are met.
- India does not agree with the above interpretation; it is of the view that, depending on the facts, an enterprise can be considered to have acquired a place of business by virtue of hosting its website on a particular server at a particular location.

It is of the view that website may constitute a PE in certain circumstances.

Whether computer equipment constitutes PE?

- Computer equipment at a given location may only constitute a PE if it meets the requirement of being fixed.

Where an enterprise operates computer equipment at a particular location, a PE may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location.

The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ('Business Profits TAG') of the OECD has issued a discussion paper exploring the interpretation and application of Article 7 to a PE carrying on e-commerce activities. The business profits to which the TAG has restricted its discussion at the moment, is "e-tailing" activities while simultaneously recognise that e-commerce is not limited to "e-tailing" and other business models do exist. However, the general principles developed in respect of "e-tailing" can equally be applied to other business models with slight adaptations depending on the facts of each situation.

Stand-alone server supporting the e-commerce activities

Where a PE consists only of a server supporting the web site through which commercial transactions and transmission of digitized products take place, most of the benefit generated by the PE is derived from exploitation of hardware and software used for the purpose. Further, such a server may also be marketing intangibles for the organization. It is very likely that the server in such a case is performing low-level automated support functions that make up only a small proportion of the functions necessary to act as a full function retail outlet/distributor. Consequently, the profits derived by such a PE are also significantly less than those earned by a full function retail outlet/distributor.

Instead of a single server, even if multiple servers are used, the observations discussed above are equally likely to apply since the functions performed do not alter substantially. A further deliberation is required as to whether some of the return pertaining to use of “e-commerce marketing intangibles” and the assumption of credit and technology risk could be attributed to the PE, since they are related to the operation of the web site itself and to the functions performed by the PE.

The analysis of the TAG has revealed that it may be difficult to determine which part of the enterprise should be treated as the economic “owner” of the “e-commerce marketing intangibles” which operates the web site itself. Further, a most difficult determination to be made relates to assumption of risks and allocation thereof to various parts of the enterprise. This requires an analysis of the conduct of parties and of the economic relationships that generally govern the relationship between independent enterprises.

Server and personnel supporting the e-commerce activities

Personnel are present at the location of the Server to ensure continuous operation of the web site and provide technical support to the customers and target customers. Therefore, in addition to the profits attributed to the server, the profits associated with such service functions should also be attributed to the PE. Further, such attribution should be on arm’s length basis. However, the profits directly associated with the exploitation of the hardware and software created by the enterprise and marketing of the intangibles shall continue to be largely attributed to the head office.

PE-Economic owner of intangibles

In this case, the hardware and software is entirely developed and constructed

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by personnel of the PE such that the PE is treated as economic owner of the intangible property. Therefore, profits directly associated with the commercial operations of such assets should be attributed to the PE using arm's length principles.

The in-house development of the server and the web site is likely to produce a more substantial attribution of profit to the permanent establishment, as it assumes sufficient development risks to be considered as the economic owner of the intangible property developed to operate the server and the web site and, therefore, is entitled to the profit associated with the exploitation of such property.

If the software is partially developed by head office and partially by the PE, the relevant proportion (determined under the arm's length principle) of the profit directly associated with the commercial exploitation of that software is attributable to the PE. Such a proportion, ordinarily, reflects the relative value of the contributions made by the PE.

- **Director of Income Tax vs. Galileo International Inc. (114 TTJ 289) (Del ITAT)**

The taxpayer, a resident of USA, had developed a fully automatic reservation and distribution systems known as Galileo systems or CRS. It maintained and operated a huge Master Computer System (MCS) in Denver, USA, which was connected inter alia to Airline servers. The taxpayer entered into Distributor agreement (DA) with a Distributor, an unrelated company, to market and distribute CRS services to travel agents (TA or subscribers) in India. The Distributor entered into Subscriber Agreements with various TAs to provide access, codes, equipment, communication link and support services to the TAs. TAs in India were connected to MCS through a communication network arranged by Societe International de Telecommunications Aeronautiques (SITA), an unrelated and independent service provider, under an agreement with the taxpayer.

The taxpayer received requests from TAs for information on bookings and forwarded the booking initiation to the Airline Servers. The response received thereto from Airlines was forwarded to TAs. The taxpayer received fees from airlines outside India but did not receive any income from TAs. The TAs were also remunerated by the airlines. The Distributor was entitled to charge fees from the TAs for providing support services, equipments, etc. but had not charged the same.

In this case, the Tribunal held as under:

- The Tribunal observed that all the subscribers in respect of which income was held taxable were situated in India. The equipment i.e. computer (including configuration) and the connectivity were provided by the taxpayer; therefore, a part of the Galileo system existed in India through which the booking took place in India.
- The Tribunal held that CSR extends to Indian Territory also in the form of connectivity in India. The booking, which was the source of revenue to the taxpayer, was possible because the request was generated from the subscriber's computers situated in India. The taxpayer did not receive the payment only for display of information but the income accrued only when the booking was completed at the desk of the subscriber's computer. In such a situation, there was a continuous seamless process involved, at least part of which was in India and hence, there was a business connection in India.
- The taxpayer exercised complete control over the computers installed at the premises of the subscribers, which were capable of performing the reservation and ticketing part of the CRS system. This amounted to a fixed place of business for carrying on the business in India. The configuration of computers and connectivity provided either directly or through the Distributor would amount to operating part of its CRS system through such subscribers in India and accordingly giving rise to PE under Article 5(1) of the DTAA in the nature of a fixed place of business in India.
- The Tribunal observed that the Distributor was authorised to enter into contract with the subscribers. Hence, Distributor was an agent of taxpayer in India. The Distributor was totally dependent on the taxpayer in respect of rendering services to subscribers in India. The Distributor was functionally as well as financially dependent entirely on the taxpayer. The Tribunal therefore, held that the Distributor was a dependent agent of the taxpayer.
- The agreements entered into by the Distributor with the subscribers under an authority granted to it, were contracts relating to operations, which constituted business proper, and not merely in the nature of internal operations. Such contracts were habitually exercised and there was nothing on record to suggest that such authority was cancelled at any point of time. The Tribunal, therefore, held that the Distributor was a dependent agent of the taxpayer who

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had habitually exercised the authority to conclude contracts on behalf of the taxpayer.

In view of the above, the Tribunal held that the taxpayer construed to have a PE in India.

With respect to the attribution of PE, the Tribunal held that having regard to the functions performed, assets used and risk undertaken (FAR analysis), 15percent of the revenue accruing to the taxpayer in respect of the bookings made in India was attributable to PE of the taxpayer in India.

Further, the Tribunal held that since the revenue attributable in respect of bookings in India was 0.45 Euro (15percent of Euro 3), and the commission paid to the Distributor was Euro 1, no income was taxable in India. Accordingly, the Tribunal relying on *CBDT circular 23 dated July 23, 1969* and Supreme Court ruling in the case of *Morgan Stanley and Co. Inc (292 ITR 416)* held that since the entire payment made to Distributor had been allowed as expense in computing the total income no income can be further charged to tax in India.

The Hon'ble Delhi High Court has upheld the above decision of Tribunal vide order dated February 25, 2009 (224 CTR 251).

- **Cargo Community Network Pte Limited (289 ITR 355) (AAR)**

The taxpayer, a tax resident of Singapore, was engaged in the business of providing access to an Internet based Air Cargo Portal known as Ezcargo at Singapore. A cargo agent, who booked cargo through various airlines, can subscribe for the portal to access the data bank of the airlines like flight schedules, availability of cargo space, etc. For these services the taxpayer charged subscription fee, system connects fee and helpdesk support fee etc.

The taxpayer had opened a liaison office (LO) in India. There were two employees in the LO acting as a link for communication between Indian subscribers (agents) and the Head Office for supplying information to the intending agents. Agents made subscription directly to the Head Office.

- The AAR observed that the use of portal is not possible without the use of server that provides Internet access to the cargo agents/subscribers on the one hand and to different airlines on the other hand for to and fro communication. Therefore, the portal and the server together constitute 'integrated commercial-cum-scientific equipment'.
- The AAR held that the use of the commercial equipment was made in India and the 'payments' arose in India.

Contentious Issues

- Server Platform is a scientific equipment, authorized to be used for commercial purposes and hence, payments made for concurrent access to utilize the sophisticated services offered by the portal, would be covered by the expression 'royalties' as used in Article 12 of the DTAA entered between India and Singapore.
- Further, the technical and consultancy services being rendered by the employees of the taxpayer in training the subscribers and providing helpdesk support, in India is covered by the description of 'FTS'. These are ancillary and subsidiary to the application and enjoyment of the use of, or the right to use, the scientific equipment for commercial purposes.
- The AAR also held that the payments bear the same character of 'royalty' and 'FTS' under the Act and chargeable to tax in India.

Hence, the payments made by the Indian subscriber (agents) to the non-resident company at Singapore, for providing a password to access and use the portal hosted from Singapore, were taxable in India and accordingly, subject to withholding tax in India.

- **Kotak Mahindra Primus vs. Deputy Director of Income Tax (105 TTJ 578) (Mum ITAT)**

The taxpayer was an Indian non-banking finance company engaged in the business of providing finance for purchase of cars. The taxpayer paid a fixed charge to the foreign company to have access to its mainframe computer systems/use of centralized database and its software applications for the running and operating of its business operations. It also paid a monthly invoice charge for the costs associated with the running of the business operations on the mainframe computer of the foreign company. In this case, the Tribunal held as under:

- The payment was made to the foreign company in consideration of its specialized data processing of the data belonging to the taxpayer. Foreign company had not granted any right or privilege to the taxpayer. The control of the taxpayer was only on the input transmission and the right was to get the output-processed data back. The actual processing of the data was in the exclusive control of the foreign company and the foreign company gets paid for this data processing.
- The payment made by the taxpayer was not for the use of or right to use of, software; the payment is for data processing. The Tribunal further

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observed that even if it is to be concluded that the payment was made for software per se, it would not lead to taxability as the payment was for a copyrighted article and not for copyright itself.

- The taxpayer did not have any control over, or physical access to, the mainframe computer in Australia. The use of mainframe computer was integral to the data processing but the fact remained that the payment was not for the use of mainframe computer per se but for the act of specialized data processing by the foreign company.
- It could not be said that the payment was made to the foreign company for the supply of any knowledge or information. The information was in fact furnished by the taxpayer the same was processed in Australia and transmitted back to the taxpayer. This activity only involved processing and, not supply of information. Accordingly, it was held that such payment cannot be considered as royalty for supply of any knowledge or information under Article 12 of the DTAA.
- The payment cannot be said to be for consultancy services. The payment cannot also be said to be for making available any technical knowledge, experience, skill, know-how or processes etc. as the recipient of services, i.e. the taxpayer, was not enabled to make use of technical knowledge on its own, without recourse to the provider of service, which is essential for making available technical knowledge, experience skill, know-how etc. It is also not covered by the any other clause of Article 12 of the DTAA.

Consequently, the Tribunal held that the payment made by the taxpayer to the foreign company cannot be held to be 'royalty' under Article 12(3) of the DTAA. Further, since the foreign company does not have any PE in India, this payment cannot also be taxed as a business profit of the foreign company in India.

- **Bharati AXA General Insurance Corporation Ltd (326 ITR 477) (AAR)**

The applicant, a company incorporated in India, was engaged in the business of general insurance. The applicant entered into a Service Agreement with AXA Asia Regional Centre Pvt. Ltd. (AXA ARC), a company incorporated in Singapore, for receiving assistance such as business support, marketing, information technology support services and strategy support etc. For rendering such services, AXA ARC charged a fee based on actual cost incurred plus a markup of five percent.

The issue raised before the AAR was whether the payments made for getting access to applications and to the server hardware system hosted in Singapore and related support under the terms of the Service agreement is in the nature of royalty / FTS under the Act or the DTAA entered between India and Singapore?

In this regard, the AAR held as under:

- Only the services which make available technical knowledge, know-how, etc., which facilitates the person acquiring the services to apply the technology, can be considered as FTS within the meaning of Article 12 of the DTAA.
- In the present case, as the applicant was unable to apply either the technology, knowledge, skills etc. possessed by AXA ARC or technical plan developed by AXA ARC, the payments made to AXA ARC for various services under the terms of the Service Agreement were not in the nature of FTS.
- Further, with respect to IT support services, the AAR observed that the payments made for accessing the system hosted in Singapore was for availing facilities provided by AXA ARC and it cannot be said that applicant had conferred any right of usage of the equipment located abroad, more so when the server was not dedicated to the applicant.

The AAR concluded that since, the services provided under the Agreement were neither FTS nor Royalty and AXA ARC did not have any permanent establishment in India, the applicant is not required to withhold tax under Section 195 of the Act.

- **IMT Labs (India) (P) Ltd., In re (157 Taxman 213) (AAR)**

In this case, the applicant had entered into a service agreement for providing technical development services to its parent company. For this purpose, the applicant was required to use 'Smarter Child' software, made by using Buddyscript technology (a scripting language), both of which were developed and owned by Conversant Inc, a non-resident American company.

Accordingly, the applicant entered into an agreement with Conversant Inc for securing license of the software, which the applicant was entitled to use. The applicant paid license fee for downloading and the use of software to the American company. The software was developed by Conversant Inc on the

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internet. The American company had to also provide one qualified staff member to assist the applicant with the transfer of technical information.

The issue raised before the AAR was whether the periodical payments made by the applicant to Conversant Inc, having no office/establishment in India, in connection with the use of software developed on internet, being 'royalties and fees for included services' as per Article 12 of DTAA between India-USA as also under Section 9 of the Act and therefore, liable to tax deduction at source.

In this regard, the AAR observed that:

- The license was granted essentially for the use of 'Smart Child' software on the American company's server platform only, for the purpose of producing, hosting and distributing 'Interactive Agent' applications. The payment of royalty was based on the number of sessions for which the equipment is utilized for the licensed purpose.
- Para 3(b) of Article 12 of the India-USA DTAA defines the term 'royalties', which means payment of any kind received as a consideration for the use of, or the right to use any industrial, commercial or scientific equipment. The 'Smart Child' application (software) on the American company's server platform is scientific equipment, licensed to be used for commercial purposes. Therefore, the payments made for producing and hosting 'Interactive Agent' applications would be covered by the expression 'royalties' as used in Article 12.
- Further, the technical and consultancy services being rendered by the technical personnel and e-mail support were covered by the description of 'fees for included services'.
- Also, such services were ancillary and subsidiary to the application and enjoyment of the use of or right to use the scientific equipment for commercial purpose.
- The definition of the term 'royalty' as per Explanation 2 to Section 9(1)(vi) of the Act was at par with the term 'royalty' used in Article 12 para 3(b). Also, the definition of the term 'FTS' as per Explanation 2 to Section 9(1) of the Act was at par with the term 'fees for included services' used in Article 12 para 4(a) of the DTAA.

Hence, payments made by the applicant to the American company, were chargeable to tax in India, under Article 12 of DTAA as also under Section 9 of the Act.

- **ITO v. Raj Television Network Ltd. ITA No. 1827 and 1828 (MDS)**

The taxpayer, a company incorporated in India, was in the business of telecasting programmes in India and abroad via satellite. The Company entered into an agreement with Reuter Television Ltd. (RTL), a company incorporated in UK, in October 1995 for availing the services of transponder and uplinking.

The company was entitled to use the transponder, a satellite located outside India. The broadcasting material, which was recorded on tapes, was sent to the uplinking station abroad. The transponder received signals and sent them back for telecasting. The Company did not get any technical services from RTL under this arrangement.

RTL did not own the transponder or the satellite through which the programmes were beamed. Intersputnik, a Russian company, owned the satellite. The agreement between the Company and RTL was terminated in September 1997 and thereafter, the Company entered into an agreement for transponder and uplinking services with Shinwatra Satellite Public Company Ltd. (SSPCL), Thailand.

The AO held that RTL had rendered services in India by beaming signals across the taxable territory in India. Further, there was a continuous business connection between the Company and RTL. Thus, the amount paid by the company to RTL was an income that accrued / arose in India to RTL and therefore, the company was required to deduct tax at source under Section 195 of the Act from such payment. Since the company failed to deduct tax, the company was held to be a taxpayer in default under Section 201(1) of the Act and liable to pay interest under Section 201(1A) of the Act. The CIT(A) reversed the order of the AO. The CIT(A) held that in the absence of PE of RTL in India, its business profits could not be taxed in India under Article 7 of the DTAA between India and UK and hence, there was no obligation to deduct tax under Section 195 of the Act.

Based on the order of the CIT(A) for the assessment year 1997-98, the revenue raised additional grounds before the Tribunal that the CIT(A) failed to consider Articles 13(3)(b) and 13(4)(b) of the DTAA defining the terms 'royalty' and FTS, respectively.

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The Tribunal affirmed the order of the CIT(A) for the year under consideration and held that:

- There was no continuity in business relation between the Company and RTL, as the agreement entered into between them in October 1995 was terminated in September 1997, and the Company had entered into an agreement with SSPCL from August 1997.
- RTL had not done anything within the territory of India and mere beaming of signal itself would not create tax liability in India. The Article 5 of the DTAA was not applicable, as RTL did not have a PE in India.
- The payments for hire of transponder were not for 'use' as specified in the definition of 'royalty' under the Act prior to its amendment with effect from 1 April 2002.
- The RBI and other Ministries approved the payment to RTL towards transponder hire charges and uplinking services and not for FTS. The agreement between the Company and RTL, being a business agreement, could not be brought under FTS.
- The provision of the DTAA cannot fasten a tax liability where the liability was not imposed under the Act. It is only when the tax liability is imposed under the Act, the DTAA may be resorted to for negating or reducing it. In support of this proposition, the Tribunal referred to the Karnataka High Court decision in *CIT v. R. M. Muthaiah* [1993] 202 ITR 508 (Kar.).

Thus, the payment for hire of transponder, not being in the nature of royalty or FTS under the Act, was not taxable in India under section 9 and hence, the Company was not liable to deduct tax at source from such payment.

- **Asia Satellite Telecommunications Company Limited v. DCIT 85 ITD 478 [ITA Nos. 166 & 861/Del./ 2001 dated 1 November 2002] (Del. Trib).**

The taxpayer, a company, registered in Hong Kong, leased its transponder to certain non-resident television channel companies, which produced television programmes and which uploaded the same outside India. The company then processed the signals uploaded by the television channel and downloaded the programme, which the cable operators received with the help of disc antennas and distributed it to the viewers in India. The company did not carry

out any operations in India nor did it receive any income in India. The company had neither any agent nor any agreement with any Indian company.

The AO held that the lease charges for transponder capacity were taxable in India under Section 9(1)(i) of the Act as there was an indirect business connection of the Company in India as the ultimate territory of commercial exploitation was in India. Before the CIT(A), the AO raised an additional ground that the payments are in the nature of 'Royalty' taxable under Section 9(1)(vi) of the Act.

The CIT(A) accepted the contention of the Company that the provisions of Section 9(1)(i) of the Act were not applicable to the facts of the case. The CIT(A), however, directed the AO to compute the income under Section 9(1)(vi) of the Act, as the latter provision was applicable.

The Delhi Bench of the Tribunal upheld the order of the CIT(A) and held that:

- Section 9(1)(i) of the Act was not applicable as no part of the operations of the business of the company were carried out in India despite the fact that the Company had a business connection in India.
- The process in the transponder was 'used' by the TV channel company for carrying on their business in India. The term 'used' in clause (iii) in Explanation 2 to Section 9(1)(vi) of the Act was interpreted to mean "taking advantage".
- The contention of the Company that there was no use of the process by the television channel companies and therefore the clause (iii) of Explanation 2 to Section 9(1)(vi) of the Act was not applicable was rejected.
- The television channel companies in the entire cycle of relaying their programmes in India were using the 'process' embedded in the company's satellites for the purpose of their business and so the payment for the same fell within the meaning of the term 'Royalty' as defined in Explanation 2 to Section 9(1)(vi) of the Act.
- A Transponder was a part of a satellite, which was fixed in the satellite and was neither moving in itself nor assisting the satellite to move. Therefore, the satellite was the equipment and the transponder, namely, a part of it, howsoever important was not 'equipment'. Hence, the leasing out of transponders to various customers in a satellite could not be equated with the leasing out of

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any equipment and the insertion of clause (iva) to Explanation 2 by the Finance Act, 2001 with effect from 1.4.2002 was not applicable.

- The statutory test for determining the place of accrual under Section 9(1)(vi)(c) of the Act was not the place where the services, for which the payments were being made, were rendered but the place where the services were utilized. If the 'source' of any income was situated in India then it was irrelevant whether the business carried on by such non-resident was in India or elsewhere. The activity that actually produced the income was not the uplinking or downlinking of the signals but the actual viewership. If the programme signals were uplinked but were not provided to the viewers, no activity capable of earning any profit would result.
- The television channel companies, being non-residents, were utilising the services of the company for earning income from advertisers and cable operators being the source in India by ultimately relaying the programmes in the Indian territories. The possibility of any channel(s) not earning income from any source in India could not be ruled out. In such a case, the lease rent earned by the company from such channel(s) were not taxable under Section 9(1)(vi) of the Act. The order of the CIT(A) was therefore modified and consequently the AO was directed to determine the income under Section 9(1)(vi)(c) of the Act protanto in the light of above discussion.

There were no precedents or rules, prohibiting both the parties from taking an additional ground before the Tribunal, which was not set out in the original memorandum of appeal.

Sections 44D and Section 115A of the Act could not be applied to the facts of the present case as the payment of royalty to the Company was made by non-resident companies and not by the Government or an Indian concern. Therefore, deduction for expenses was admissible from royalty income.

The nature of income was not effected by Section 9 of the Act and if the activity otherwise qualified as 'business' then the income derived therefrom had to be taxed under the head "business income".

Depreciation allowable to the company on the satellite had to be apportioned, as income taxable in India was relatable to a part of the satellite. There was a difference between the income, which was exempt from tax and income, which was outside the charging section. Apart from the fact that the decision

of the Supreme Court in *Rajasthan State Warehousing Corporation v CIT [2000] 242 ITR 450* had been rendered meaningless after insertion of Section 14A of the Act, its ratio was applicable only in respect of exempt income and not to income, which do not fall within the scope of total income at all.

As regards the cost of the satellite eligible for depreciation, the Tribunal held that the actual cost would be considered for this purpose and not the written down value as computed by the AO, as depreciation has not been actually allowed.

Section 44C of the Act was not attracted as there was no branch in India relying on the decision of the Calcutta High Court in the case of *Rupen Juli Tea Company Ltd. Vs CIT (1990) 186 ITR 301*.

The conversion rate of Hong Kong Dollars into Indian Rupees for computing the income would be the rate prescribed under the Rules.

If tax was 'deductible' from income paid to the company during the year, no interest under Section 234-B of the Act was leviable irrespective of the fact that no tax was actually deducted at source. The opening words of Section 195(1) of the Act cast an obligation on 'any person' for deduction of tax at source who is responsible for paying to a foreign company, any amount chargeable to tax in India. "any person" referred to in that section could be a resident or a non-resident. Therefore, the liability to deduct tax at source from payments made by the TV channel companies to the company was fastened on them by virtue of the provisions of Section 195 of the Act.

- **Panamsat International Systems LLC (103 TTJ 861)(Del ITAT)**

In the said case, the taxpayer was operating a global network of telecommunication satellites (comprising of transponders), which were located in outer space, above the earth. It was in the business of providing service of such transponders to various TV channel companies for the purpose of transmission of their channels. The channel companies entered into agreements with the taxpayer to use its transponder facility to make available the TV signals to cable operators in various geographical areas, who, in turn, distributed the signals to the viewers. The taxpayer received transponder hire charges from the channel companies.

The Tribunal held that the definition of 'Royalty' in terms of Article 12 of the DTAA entered between India and USA, inter alia includes "payment for any copyright...model, plan, **secret formula or process**, or" Thus, unlike the Royalty definition as per the Act, the definition under the DTAA between

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India and USA specifically provides a comma after the word 'process'. Therefore, the term 'secret' applies, both, to 'formula' as well as 'process'. Hence, under the DTAA entered between India and USA, payment for process which is not "secret" would not amount to 'Royalty'.

Since, there was nothing secret about the process involved in the operation of a transponder, the payment for the use of the process does not amount to royalty within the meaning of Article 12.3(a) of DTAA between India and USA.

Further, the Tribunal observed that the Agreement indicated that the payment represented the consideration for the use of a "facility" and not for the use of any "process. Hence, would not fall within the definition of 'Royalty'.

- **New Skies Satellites N.V. v. ADIT (2009) 319 ITR (AT) 269 (Del ITAT)**

The taxpayers owned and operated a network of telecommunication satellites located at a height of about 36,000 km above the earth. They offered video, internet, data and voice communication services to a range of broadcasters, internet service providers, telecommunication companies, etc. around the world. For providing these services, the taxpayers, used their own assets and infrastructure comprising their satellites, control centers, etc. all located outside of India, which were controlled, operated and maintained by them exclusively. The issue before the Tribunal was whether the charges earned by the taxpayers for provision of transponder capacity constitutes royalty, as they entail use of a process within the transponders by the customers.

The Tribunal held that to fall under the definition of royalty, it is not necessary that the consideration be for the use of intellectual property rights only. The process, as mentioned in the definition of royalty under the provisions of the Act as well as DTAA, can be any process. The same is not required to be a 'secret'. Hence, there is no difference in interpreting the definition of royalty under the Act as well as DTAA. The payments received by the taxpayers from the customers were on account of the use of process involved in the transponder and the amounts to royalty within the meaning of Section 9(1)(vi) of the Act. They also amount to royalty within the meaning of the respective Articles of DTAA.

Taxation of E-commerce

The supply and procurement of digital goods and services have undergone exponential expansion everywhere, due to the expansion of information and

communication technology. The rules of international taxation have yet to evolve despite the runaway growth in digital and internet transactions in recent times, prompting many countries and the OECD to recommend alternate methods of garnering revenue from these digital transactions.

OECD recommendation to tax digital transactions

The OECD has recommended, in BEPS project under Action Plan 1, several options to tackle the direct tax challenges, which include

- (i) modifying the existing PE rule to include that where an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country's economy. It further recommended a virtual fixed place of business PE in the concept of PE i.e. creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.
- (ii) Impose a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider, or
- (iii) Imposition of an "Equalisation Levy" on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

The BEPS action Plan 1 has admitted that the options analysed by the Task Force on Digital Economy to address the broader direct tax challenges, would require substantial changes to key international tax standards and would require further work.

CBDT released E-commerce Taxation Committee Report

CBDT released a report of the "Committee on Taxation of E-Commerce" ("the Committee") that led to the introduction of 'Equalization Levy' in the Finance Bill, 2016.

- The members of the Committee comprising of senior officials from the Finance Ministry and Income-tax department, etc. suggested that it would be a preferable option to restrict the rate of Equalization Levy at 6% at the time of its introduction, and evaluate the increase in rate of tax in later years.
- The Committee recommended levy on specified digital services and facilities including online marketing and advertisements, cloud computing, website designing hosting and maintenance, digital

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space, digital platforms for sale of goods and services and online use or download of software and applications.

- The Committee examined the OECD's BEPS recommendations in Action Plan 1 and after examining the three options in the BEPS, report noted that "first two options, i.e. a new nexus based on significant economic presence and the withholding tax on digital transactions would require changes in a number of tax treaties.
- The third option of 'Equalization Levy' provides a simpler option that can be adopted under domestic laws without needing amendment of a large number of tax treaties";
- The report holds that the 'Equalization Levy' on digital transactions would not be a tax on income, and hence would not be covered by tax treaties.
- The Committee also recommended that Equalization Levy would need to be imposed outside the Income-tax Act, 1961 since it is not proposed as tax on income'.
- The Committee also noted that deduction by payment gateways and by authorized foreign exchange dealers can significantly reduce the obligations on payers, and thus recommends that work should be initiated for exploring this possibility.

Equalisation Levy

Currently in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. The new business models have created new tax challenges. The typical direct tax issues relating to e-commerce are the difficulties of characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction, the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes. The digital business fundamentally challenges physical presence-based PE rules. If PE principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e. place of business, location, and permanency must be reconciled with the new digital reality. Considering the potential of new digital economy and the rapidly evolving nature of business operations, and to address the challenges in terms of taxation of such digital transactions as mentioned above, a new Chapter titled 'Equalisation Levy' is inserted in the Finance Act 2016. The

'Equalisation Levy' is introduced on some e-commerce transactions, which currently escape India's tax reach. Equalisation Levy is to apply in line with the recommendation of the OECD BEPS project.

The Equalisation Levy is to be 6 percent of the amount of consideration for specified services received or receivable by a non-resident payee not having a PE in India. The Equalisation Levy is to be levied and recovered from the payer being a person resident in India engaged in carrying on business/profession or a non-resident having a PE in India. Correspondingly, such income would be exempt from income tax in the hands of a non-resident recipient.

Specified services have been defined to mean online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other notified services.

The provision of an Equalisation Levy not to apply if:

- The non-resident recipient has a PE in India and the specified services are effectively connected with such a PE;
- The aggregate amount of consideration received/receivable in a year does not exceed INR 1 lakh; or
- The payment for the specified service is not for the purposes of carrying out business or profession.

The payer will not be entitled to a deduction of such specified services payments to non-residents if the Equalisation Levy is not withheld or after withholding it is not deposited with the government by due date. Such expenditure is to be allowed as deduction to the payer in the year of payment of Equalisation Levy.

The Equalisation Levy is to be governed by a separate chapter, which is a code in itself covering establishment of statutory authorities, filings, assessments, penalty and other procedures.

Application of the Double Tax Avoidance Agreement with Equalisation Levy

Chapter VIII of Finance Bill, 2016, does not become part of the Income-tax Act. Accordingly, it will remain a separate tax, and therefore, DTAA are not applicable to Equalisation Levy.

Tax implications in the hands of a foreign company

The BEPS Action Plan 1, with regards to the claim of credit of tax stated that

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imposing an equalisation levy raises risks that the same income would be subject to both corporate income tax and the levy.

In the case of a foreign entity, for example, if the income is subject to corporate income tax in the country of residence of the enterprise, the levy would be unlikely to be creditable against that tax since the income on which the Equalisation Levy is chargeable; the income is exempted under Section 10 of the Act.

The foreign suppliers may factor – in the cost of the levy in the value of the contract and may not bear the levy, which may negate the objective sought to be achieved by the Government of ensuring equal treatment.

Significant Economic Presence

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on 'significant economic presence' (SEP). As per the Action Plan 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a SEP in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools.

The scope of existing provisions of Section 9(1)(i) is restrictive as it essentially provides for physical presence based nexus rule for taxation of business income of the non-resident in India. Explanation 2 to the said section which defines 'business connection' is also narrow in its scope since it limits the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent. Therefore, emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, is not covered within the scope of Section 9(1)(i) of the Act.

In view of the above, the Finance Act, 2018 amended Section 9(1)(i) of the Act to provide that 'significant economic presence' (SEP) in India shall also constitute 'business connection'. Further, SEP for this purpose shall mean-

- (i) Any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed; or

- (ii) Systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

Only so much of income as is attributable to such transactions or activities shall be deemed to accrue or arise in India. The transactions or activities shall constitute SEP in India, whether or not the non-resident has a residence or place of business in India or renders services in India.

Report on proposed amendments of rules for profit attribution to permanent establishment in India

Recognising the significance of issues relating to attribution of profits to a PE as well as the need to bring greater clarity and predictability in the applicable tax regime, a Committee was formed by the Central Board of Direct Taxes (CBDT) to examine the existing scheme of profit attribution to PE and recommend changes in current domestic tax law (Rule 10 of the Income-tax Rules, 1962 (the Rules)).

Profit attribution in case of SEP based on four factors - In the cases where the business connection is primarily constituted by the existence of users beyond the prescribed threshold in India, the profits attributable to India shall be determined by apportioning the 'Profits derived from India' on the basis of four factors of sales, employees (manpower & wages), assets and users as under:

- In cases of low and medium user intensity - 10 per cent weight to users and 30 per cent each to other three factors

$\text{Profits attributable to operations in India} = \text{'Profits derived from India'} \times [0.3 \times \text{SI/ST} + (0.15 \times \text{NI/NT}) + (0.15 \times \text{WI/WT}) + (0.3 \times \text{AI/3xAT})] + 0.1]$
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- In cases of high user intensity - 20 per cent weight to users, 25 per cent each to asset and employees and 30 per cent to sales

$\text{Profits attributable to operations in India} = \text{'Profits derived from India'} \times [0.3 \times \text{SI/ST} + (0.125 \times \text{NI/NT}) + (0.125 \times \text{WI/WT}) + (0.25 \times \text{AI/3} \times \text{AT})] + 0.2]$

8.3 Indirect transfer of assets

Income deemed to accrue or arise in India

As per the provisions of Section 5 read with Section 9 of the Act, any **income deemed to accrue or arise to a non-resident in India is chargeable to tax in India**. Under Section 9(1)(i) of the Act, a non-resident is liable to tax in India on the income accruing or arising in India, which, inter-alia, includes **income accruing or arising from any asset or source of income in India or through transfer of a capital asset situate in India**.

Background of the controversy

Typically, the taxpayers were of the view that Section 9 seeks to tax capital gains only if they arise from transfer of capital assets situated in India. Accordingly, if a transaction involved the transfer of shares of a foreign company outside India, it should not be taxable in India. Further, a share represents a bundle of rights and the transfer of a share results in a transfer of all the underlying rights. However, in law, what is transferred is a share and not individual rights. There is a distinction in law between shareholders and the company and the shareholder has no rights in the assets of the company. Hence, the transfer of the share in a foreign company cannot result in the transfer of assets in India. Absent the “look-through” rule¹², no tax can be imposed in respect of such transaction under Section 9 of the Act.

On the other hand, the tax department was of the view that the transfer of foreign company shares constitutes a transfer of composite rights in the Indian company by such foreign company. Also, several vital rights having direct nexus with India (for e.g. including license to conduct a business in India, management rights, loans, option agreements, branch license, etc.) may be transferred due to transfer of such shares. Accordingly, the transaction should be chargeable to tax in India and the purchaser company should be required to withhold appropriate taxes on payments made to the seller.

On the above issue, several companies, for e.g. Vodafone International Holdings B.V., AT&T of the U.S. Britain's SABMiller PLC, etc. were fighting similar tax claims and the Indian tax authorities had been handing out tax notices to them.

¹² “Look-through” rule provides that the tax be imposed on gains arising out of a transfer of shares outside the country if it results in the passing of control over a company, which holds specified assets/property in the country.

The case of Vodafone International Holdings B.V., nearly a five-year old controversy, which was surrounding the taxability in India of offshore transfer of shares of a Cayman Islands company by the Hutchison Group to the Vodafone Group, reached the Supreme Court of India. In a landmark decision, the Supreme Court reversed the decision of the Bombay High Court and held that the Indian tax authorities did not have territorial jurisdiction to tax the offshore transaction, and therefore, Vodafone was not liable to withhold Indian taxes.

- **Vodafone International Holdings B.V. – Supreme Court**

Facts of the case

In February 2007, Vodafone International Holdings B.V (Vodafone or VIH), a Dutch entity, had acquired 100 percent shares in CGP (Holdings) Limited (CGP), a Cayman Islands company for USD 11.1 billion from Hutchinson Telecommunications International Limited (HTIL). CGP, through various intermediate companies/ contractual arrangements controlled 67 percent of Hutchison Essar Limited (HEL), an Indian company. The acquisition resulted in Vodafone acquiring control over CGP and its downstream subsidiaries including, ultimately, HEL. HEL was a joint venture between the Hutchinson group and the Essar group. It had obtained telecom licences to provide cellular telephony in different circles in India from November 1994.

The controversy

The tax department issued a show-cause notice to Vodafone to explain why tax was not withheld on payments made to HTIL in relation to the above transaction. The tax department contended that the transaction of transfer of shares in CGP had the effect of indirect transfer of assets situated in India.

Also, they had jurisdiction to proceed against Vodafone for their alleged failure to withhold tax from payments made under Section 201 of the Act.

The Supreme Court's judgment¹³

The three-judge bench of the Supreme Court delivered its verdict on the case on 20 January 2012. The key highlights of the decision are as under:

Interpretation of Section 9(1)(i) of the Act

In relation to Section 9(1)(i) of the Act, the Supreme Court observed that:

¹³ Vodafone International Holdings B.V. v. Union of India [2012] 17 taxmann.com 202 (SC)

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- Charge to capital gains under Section 9(1)(i) of the Act arises on existence of three elements, viz., transfer, existence of a capital asset and situation of such asset in India.
- The legislature has not used the words 'indirect transfer' in Section 9(1)(i) of the Act. Section 9(1)(i) of the Act does not have 'look through' provisions, and it cannot be extended to cover indirect transfers of capital assets/ property situated in India.
- A legal fiction has a limited scope and it cannot be expanded by giving purposive interpretation, particularly if the result of such interpretation is to transform the concept of chargeability, which is also there in Section 9(1)(i) of the Act.

Accordingly, the Supreme Court concluded that the transfer of the share in CGP did not result in the transfer of a capital asset situated in India, and gains from such transfer could not be subject to Indian tax.

The situs of the shares

Under the Indian Companies Act, 1956, the situs of the shares would be where the company is incorporated and where its shares can be transferred. In the present case, it was asserted that transfer of CGP shares were recorded in Cayman Island.

The Supreme Court also rejected the argument of the Revenue that since CGP was a mere holding company, the situs of its share was situated in India where its underlying assets were located.

Holding and Subsidiary structures

In relation to the issue of "substance" in a subsidiary company, the Supreme Court observed as follows:

- It is a common practice in international law, which is the basis of international taxation, for foreign investors to invest in Indian companies through an interposed foreign holding or operating companies, such as a Cayman Islands or Mauritius based company for both, tax and business purposes.
- If a Non-Resident makes an indirect transfer through abuse of the organisation form/ legal form and without a reasonable business purpose, which results in tax avoidance or avoidance of withholding tax, then the tax authorities may disregard the form of the arrangement or the impugned action through use of holding

companies and may re-characterize the equity transfer according to its economic substance and impose tax.

The Supreme Court also went on to conclude that the corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device.

On the applicability of withholding tax (Section 195 of the Act)

The Supreme Court held that the question of withholding tax at source would not arise, as the subject matter of offshore transfer between the two non-residents was not liable to capital gains tax in India.

Extinguishment of HTIL's interests

In this context, the Supreme Court reiterated the 'look at' principle enunciated in Ramsay case, in which it was held that the Revenue or the Court must look at a document or a transaction in a context to which it properly belongs.

It is the task of the Revenue/ Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole, and not adopt a dissecting approach.

By applying the 'look at' test discussed above, the Supreme Court held that extinguishment took place because of the transfer of the CGP share and not by virtue of various clauses of SPA.

Anti-avoidance Rules

The authorities may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant. Every strategic foreign investment coming into India should be looked at in a holistic manner, bearing in mind factors such as: the concept of participation in investment, the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; and the continuity of business on such exit.

Merely because at the time of exit, capital gains tax becomes not payable or exigible to tax would not make the entire "share sale" (investment) a sham or a tax avoidant.

The question of providing "look through" in the Statute or in the tax treaty is a matter of policy and has to be expressly provided for. Similarly, Limitation of

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Benefits (LOB) has to be expressly provided for in the tax treaty. Such clauses cannot be read into the Section by interpretation.

Conclusion

The Supreme Court held that gains arising from the said transaction were not liable to tax in India, and that therefore there was no obligation on Vodafone to deduct tax at source.

Section 9, 195 and other provisions amended by the Finance Act 2012

The Finance Act, 2012, with the aim to retrospectively overcome many judicial decisions, notably the Supreme Court decision in the case of Vodafone International Holding B. V., and tax the offshore transfers of shares or interest in a company outside India, if its value is derived substantially from assets located in India, amended specific provisions of the Act, inter alia, including Sections 9 and 195.

By way of amendment to provisions of Section 9 of the Act, the scope of income deemed to accrue or arise in India to non-residents, directly or indirectly, through the transfer of a capital asset situated in India expanded retrospectively from 1 April 1962 to tax indirect transfer of shares in an Indian Company. The expression 'through' is clarified to always mean "by means of", "in consequence of", or "by reason of". It is clarified that the share or interest in an overseas company or entity to be situated in India if they directly or indirectly derive value substantially from assets located in India. The term 'property' is clarified to include rights in or in relation to an Indian company including rights of management or control or any other such rights. The ambit of 'transfer' in such cases widened to include disposition of share of company registered / incorporated outside India where it relates to such 'property'.

By way of amendment to provisions of Section 195 of the Act, the scope of withholding tax obligation on payment of income to non-resident expressly extended to all persons including non-residents irrespective of them having a residence or place of business or business connection or any other presence in India.

Also, a validation clause is introduced with respect to demands raised on non-residents under above retrospective provisions to protect against any question that tax was not chargeable on such transactions on any ground and which shall operate notwithstanding any judgment, decree or order of any Court or Tribunal or any Authority.

Report of the Expert Committee

The Prime Minister referred¹⁴ an issue to the Expert Committee (the Committee), on the implications of amendment made to the Act relating to the taxation of overseas transfer of assets where the underlying asset is in India, in the context of all non-resident taxpayers. Based on consultations and written representations received from various stakeholders, the Committee has issued a draft report on the above issue.

According to the Committee, the retrospective amendments in relation to the indirect transfer are neither clarificatory in nature nor in accordance with the global practice. Further the Committee also stated that based on the principles of equity and probity in taxation, such amendments should be applied prospectively. Specifically, the recommendation to limit the use of retrospective amendments to exceptional cases and to avoid using it to expand the tax base is also significant. In addition to the above, the Committee has also examined in detail several aspects of the amendments including the issues surrounding the lack of clarity on the meaning of terms used in the amendments, and has made several suggestions in this regard. The Committee has also recommended that interest and penalty should not be levied when there is a tax demand due to such amendments.

The report suggests that some of these recommendations will require legislative changes whereas some can be effectuated by means of Departmental Circulars. It was a draft report where the public comments have were invited.

CBDT sets-up a Committee to examine fresh cases referred by the tax officer in respect of indirect transfer of assets prior to 1 April 2012

The CBDT has issued the Order¹⁵ under Section 119 of the Act (the order), for proper administration of all fresh cases arising out of the retrospective amendments of 2012 in respect of indirect transfers. In brief, the order provides that if the AO considers that any income is deemed to accrue or arise in India before 1 April 2012, through a transfer of a capital asset situate in India due to such retrospective amendments, he shall seek prior approval of the Committee for the proposed action. Accordingly, the fresh cases will be selected after the Committee has examined the issue and given an

¹⁴ Notification dated 30 July 2012 and 1 September 2012

¹⁵ CBDT Order F.No. 149/141/2014-TPL, dated 28 August 2014

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opportunity of hearing to the taxpayers. This will provide relief to the taxpayers from unwanted litigation on indirect transfer of asset situated in India.

Amendments by the Finance Act 2015

In order to bring in much needed clarity in the manner of taxing indirect transfer of assets in India, certain amendments were brought about in the provisions of the Act.

In cases of indirect transfers (i.e. transfer of shares of foreign company deriving substantial value from shares of Indian company/assets located in India), the following key amendments were made:

- The share or interest of foreign company / foreign entity is deemed to derive its value substantially from Indian assets, if on the specified date (date of transfer or last day of accounting year as stipulated), the value of such Indian assets exceeds INR 100 million and it represents at least fifty per cent of the value of all the assets owned by the foreign company or entity.
- The value of the assets to be its FMV (without reduction of corresponding liabilities) and the underlying aggregate gains to be apportioned proportionately to Indian assets as per methods to be prescribed.
- Indirect transfer provisions would not apply to the transferor shareholder of the foreign company holding the Indian assets directly and whose shares/ interest are getting transferred if the transferor (along with the AEs) has neither the right to control or manage the foreign company nor holds voting power or share capital or interest exceeding five per cent therein.
- Indirect transfer provisions would not apply to the transfer or shareholder of the foreign company holding the Indian assets indirectly and whose shares/interest are getting transferred if the transfer or (along with AEs) has neither the right to control or manage the foreign company or the direct holding company nor holds voting power or share capital or interest exceeding five per cent in the direct holding company by virtue of holding in the foreign company.
- Reporting obligation casted on Indian concern, through or in which the Indian assets, are held by the foreign company or the foreign entity and any non-compliances to attract penal consequences.

Further, the Finance Act, 2015 has introduced Section 47 (vcc) in the Act which, subject to fulfillment of certain conditions provides that transfer of shares of a foreign company (which directly or indirectly derives its value substantially from shares of an Indian company) by the demerged foreign company to the resulting foreign company under a scheme of demerger will not be regarded as transfer.

Controversies

Controversies in this case have centered around the following areas:

- Impact of amended definition of 'transfer' and 'capital asset'
- Methods for determining value derived from India
- Withholding tax liability on past transactions
- Whether the interest levy on demand arising as a result of retrospective amendment should be restricted to the prospective period
- Whether penalty proceedings can be initiated in respect of alleged understatement of income due to retrospective amendment
- Whether the payer of income should be considered as a representative assessee, on a prospective basis.
- Interpretation of the phrase 'assets located in India' mentioned in Explanation 5 to Section 9(1)(i) of the Act
- Availability of treaty benefits. This issue is covered, inter alia, by the Andhra Pradesh High Court decision in the case of Sanofi Pasteur Holding SA (discussed below).
- Scope of 'substantially' occurring in Explanation 5 to Section 9(1)(i) of the Act. This issue is covered, inter alia, by the Delhi High Court's decision in the case of Copal Research Ltd., Mauritius (discussed below).

Due to the tax liability being levied and/or tax notices being issued to certain companies; they have resorted to the protection offered to them under the Bilateral Investment Promotion and Protection Agreement¹⁶ (BIPA).

¹⁶ As part of the Economic Reforms Programme initiated in 1991, the foreign investment policy of the Government of India was liberalised and negotiations undertaken with a number of countries to enter into BIPAs in order to promote and

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CBDT issues draft rules for computation of fair market value and reporting requirement in relation to indirect transfer provisions

CBDT has prescribed the manner of computation of fair market value of assets of the foreign company or entity and the reporting requirements by the Indian concern through the amendments of the Income-tax Rules, 1962. Forms for reporting requirements have also been prescribed.

The rules provide the mechanism to compute the fair market value in different scenarios. It has also burdened the Indian concern with the onerous requirement of maintaining detailed documents that to for the period of eight years.

Judicial precedents in relation to indirect transfer

- **GEA Refrigeration Technologies GmbH [2018] 401 ITR 115 (AAR)**

The AAR held that capital gains arising from indirect transfer of shares of an Indian company on sale of shares of German company shall not be taxable in India under the provisions of Section 9(1)(i) the Act. German company has derived its value substantially from its other companies whereas its value of assets in Indian company is a mere 5.40 per cent, far lower than the requirement of 50 per cent. Hence, it fails the test of deriving value substantially from the Indian company.

Since the AAR ruled that the gains arising from the indirect transfer of shares of Bock GmbH are not chargeable to tax in India in view of the provisions of the Act, in view of Section 90(2) of the Act, the applicant would be entitled to take advantage of the provision that was more beneficial to it.

The AAR thus held that since the transfer is effected in Germany, and the payments have also been made in Germany, the gains arising from the alienation of shares by the shareholders of Bock GmbH can be brought to tax only in Germany.

- **DIT v. Copal Research Ltd., Mauritius [2014] 49 taxmann.com 125 (Del)**

Copal Research Limited (CRL or the taxpayer) was a company incorporated

protect on reciprocal basis investment of the investors. Government of India have, so far, (as on July 2009) signed BIPAs with 75 countries out of which 66 BIPAs have already come into force and the remaining agreements are in the process of being enforced.

under the laws of Mauritius, Copal Research India Private Limited (CRIL) was an Indian company and Copal Partners Limited (Copal-Jersey) was a company incorporated in Jersey. CRL, CRIL and Copal-Jersey were companies belonging to the 'Copal Group'. CRIL was a wholly owned subsidiary of CRL. Copal Group Shareholders entered into a Share Purchase Agreement with Moody-UK for sale of approximately 67 per cent of the shares of Jersey to Moody-UK. Also, CMRL (a Mauritius company) sold shares of E Inc. (a USA company) to M-USA (a USA company), which resulted in indirect transfer of EIL (Indian Company).

The AAR, inter alia, held that the capital gains arising out of the sale of shares of an Indian Company - CRIL, sold by a company incorporated in Mauritius to a UK based company were not liable to tax, in India, in the hands of the seller companies. Also, the capital gains arising from sale of shares resulting in indirect transfer of EIL are not liable to tax in India.

The Delhi High Court dismissed the Revenue's writ petitions against AAR ruling. The High Court held that the transaction structured has not been done for the purposes of avoiding tax. There was no material to indicate that the commercial transaction was not bonafide. Only a fraction of the value of shares of Copal-Jersey was indirectly derived from the value of the shares of CRIL and EIL. 'Substantially' occurring in Explanation 5 would necessarily have to be read as synonymous to 'principally', 'mainly' or at least 'majority'. Explanation 5 do not enlarge the scope of Section 9(1)(i) of the Act. Accordingly, the transfer of overseas asset, which derives less than 50 per cent of its value from assets situated in India, would not be taxable in India.

- **Sanofi Pasteur Holding SA v. Department of Revenue [2013] 30 taxmann.com 222 (AP)**

Shantha Biotechnics Limited (SBL) is a company incorporated under the Companies Act, 1956 having its registered office in Hyderabad, India. Sanofi Pasteur Holding (Sanofi) is a company incorporated under the laws of France. During the year 2009, Sanofi had purchased 80.37 percent of the share capital of another French company (i.e. ShanH) from Merieux Alliance (MA), a French company, and balance 19.63 percent share capital of ShanH from Groupe Industriel Marcel Dassault (GIMD), another French company. ShanH held 82.5 percent of the share capital of SBL. The tax department passed an order on Sanofi under Section 201(1)/(1A) of the Act holding Sanofi as an 'assessee-in-default' for not withholding taxes on payments made to MA and GIMD on acquisition of shares of ShanH

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Copal-

The AAR ruled that the capital gain arising from the sale of shares of ShanH by MA and GIMD was taxable in India in terms of Article 14(5) of the tax treaty. The Andhra Pradesh High Court (High Court) observed that ShanH as a French resident corporate entity is a distinct entity of commercial substance, distinct from MA and GIMD. It was incorporated to serve as an investment vehicle, this being the commercial substance and business purpose i.e. of foreign direct investment in India by way of participation in SBL. ShanH received and continues to receive dividends on its SBL shareholding, which have been and are assessable to tax under provisions of the Act; and even post the transaction in issue, the commercial and business purpose of ShanH, as an investment vehicle is intact. These indicators/factors are, in the light of Vodafone International Holdings B. V.2, adequate base to legitimize the conclusion that ShanH is not a sham or conceived only for Indian tax-avoidance structure. De hors the conclusion that there was no case piercing the corporate veil of ShanH, the transaction in issue was clearly one of transfer by MA and GIMD of their shareholding in ShanH to Sanofi and it was not a case of transfer of shareholding in SBL, which continues with ShanH. The present transaction was for alienation of 100 percent of shares of ShanH held by MA and GIMD in favour of Sanofi and such transaction fall within Article 14(5) of the India-France tax treaty (tax treaty). The transaction neither constitutes the transfer nor deemed transfer of shares or of the control/management or underlying assets of SBL. The controlling interest of ShanH over the affairs, assets and management of SBL being identical to its shareholding and not a separate asset, it cannot be considered or computed as a distinctive value. The assets of SBL cannot be considered as belonging to a shareholder (even if a majority shareholder). The value of the controlling rights over SBL attributable to ShanH shareholding is also incapable of determination and computation. For these reasons, the computation component, which is inextricably, integrated to the charging provision (Section 45 of the Act) fails, and consequently the charging provision would not apply. The transaction was not liable to tax in India under the provisions of the Act read with the provisions of the tax treaty. Further, the retrospective amendments in Section 2(47), Section 4, Section 5 and Section 9 of the Act are not fortified by a non-obstante clause to override the provisions of the tax treaties. Accordingly, it was held that the capital gains arising from transfer of shares of a French company, which in turn held controlling stake in an Indian operating company is taxable in France and not in India.

8.4 Retrospective amendment

Background

If any provision of a law is amended with effect from a date that is prior to the date of amendment, then it is called retrospective amendment. For example, the Finance Act, 2012, has amended the certain provisions of Section 9 with effect from 1 April 1962, which is a retrospective amendment.

In the recent past, there has been an increasing tendency to negate certain judicial precedents, in particular those that have gone in favour of the assessee, by introducing the retrospective amendments with the Finance Acts. These amendments not only neutralized that tax benefit derived by a taxpayer because of the beneficial provisions, but also levied penalty, interest, etc. on the taxpayer.

Retrospective amendments prior to 2012

The Finance Act, 2012 has introduced significant retrospective amendments. However, prior to that certain retrospective amendments were introduced which are listed below:

- Clarificatory amendment in respect of reassessment proceeding under section 147 – Earlier, the provisions of section 147 provided, inter alia, that if the Assessing Officer has reason to believe that any income chargeable to tax has escaped assessment for any assessment year, he may assess or reassess such income after recording reasons for re-opening the assessment. Further, he may also assess or reassess such other income which has escaped assessment and which comes to his notice subsequently in the course of proceedings under this section. However, some courts had held that the AO has to restrict the reassessment proceedings only to issues in respect of which the reasons have been recorded for reopening the assessment. With a view to further clarifying the legislative intent, the Finance Act, 2009, inserted the Explanation 3 in section 147 to provide that the AO may assess or reassess income in respect of any issue, which comes to his notice subsequently in the course of proceedings under this Section, notwithstanding that the reason for such issue has not been included in the reasons recorded under sub-section (2) of section 148.
- Clarification regarding add back of 'provision for diminution in the value of asset', while computing book profits - The Finance (No. 2)

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Act, 2009, inserted a new clause (i) in Explanation 1 after sub-section (2) of the said section so as to provide that if any provision for diminution in the value of any asset has been debited to the profit and loss account, it shall be added to the net profit as shown in the profit and loss account for the purpose of computation of book profit. This amendment is effective retrospectively from 1 April 2001 and is applicable in relation to AY 2001-02 and subsequent assessment years.

- Amendment in Chapter VIA to prevent abuse of tax incentives – The government observed that the scope of the deductions under various provisions of Chapter VIA overlap therefore, some taxpayers, at times, claim multiple deductions for the same profits. With a view to preventing such misuse, the Finance (No. 2) Act, 2009, amended the provisions of section 80A of the Act to provide the following, namely:-
- Deduction in respect of profits and gains shall not be allowed under any provisions of section 10A or section 10AA or section 10B or section 10BA or under any provisions of Chapter VIA under the heading "C.-Deductions in respect of certain incomes" in any assessment year, if a deduction in respect of same amount under any of the aforesaid has been allowed in the same assessment year;
- the aggregate of the deductions under the various provisions referred to in above, shall not exceed the profits and gains of the undertaking or unit or enterprise or eligible business, as the case may be;
- no deductions under the various provisions referred above, shall be allowed if the deduction has not been claimed in the return of income.

These amendments took effect retrospectively from 1 April 2003, and applied in relation to AY 2003-2004 and subsequent years.

It is pertinent to note that the Finance (No. 2) Act, 2009, had introduced retrospective amendment in Section 80-IA, Section 80-IB, Section 80CCD, Section 115JA, Section 132, Section 271, etc.

Retrospective amendments through the Finance Act, 2012

The Finance Act 2012, overcame retrospectively many judicial decisions, notably the Supreme Court decision with regard to Vodafone and it taxes the offshore transfers of shares/interest in a company/entity outside India, if its value is derived substantially from assets located in India. Similarly, tax

provisions would re-characterise all payments made for computer software and amounts received for transmission of signals by satellite to bring them within the ambit of Royalty and thus subject these to source rule taxation in India. Further, continuing in the vein of overruling favourable court decisions, retrospective amendments in Transfer Pricing provisions would deny the benefit of the 5 percent variation as a standard deduction, and will considerably widen the ambit of transactions that need to satisfy India's narrow arm's length standard of arithmetic mean.

A validation clause introduced with respect to demands raised on non-residents under above retrospective provisions to protect against any question that tax was not chargeable on such transactions on any ground and which shall operate notwithstanding any judgment, decree or order of any Court or Tribunal or any Authority.

The Government's stance on overruling favourable judicial pronouncements through retrospective amendments in the law did little to increase the confidence in the economic environment in the country.

CBDT clarifies regarding reopening of completed assessments on account of certain retrospective amendments in the Finance Act, 2012

On May 2012, the CBDT issued a clarification regarding reopening of completed assessments on account of certain retrospective amendments in the Finance Act, 2012. The clarification is summarised as follows:

- The clarification stated that the aforesaid amendments have been introduced retrospectively in order to clarify the legislative intent and state the position of law from the date of coming into effect of these sections in the Act.
- Certain doubts have been raised about the implication of these amendments on the assessments that have already been completed and attained finality.
- In view of above the CBDT has clarified that:
- In case where assessment proceedings have been completed under section 143(3) of the Act, before the 1 April 2012 and no notice for reassessment has been issued prior to that date; then such cases shall not be reopened under section 147/148 of the Act on account of the abovementioned clarificatory amendments introduced by the Finance Act, 2012.

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- However, assessment or any other order, which stands validated due to the said clarificatory amendments in the Finance Act, 2012 would of course be enforced.

The Budget 2014-2015 Speech

The Finance Minister in his speech of the Budget 2014-15, in relation to tax administration, mentioned the following:

- This Government will not ordinarily bring about any change retrospectively, which creates a fresh liability.
- It is committed to provide a stable and predictable taxation regime that would be investor friendly and spur growth.
- Henceforth, all fresh cases arising out of the retrospective amendments of 2012 in respect of indirect transfers and coming to the notice of the Assessing Officers will be scrutinized by a High Level Committee to be constituted by the CBDT before any action is initiated in such cases.

CBDT sets-up a Committee to examine fresh cases referred by the tax officer in respect of indirect transfer of assets prior to 1 April 2012

Please refer to the topic 8.3 'Indirect transfer of assets'.

Developments in relation to International Arbitration

Recent news reports indicate that the Cairn Energy's (a UK based company) arbitration against the retrospective tax demand has begun with the adjudicating panel fixing timelines to complete the arbitration in less than 12 months. The seat of the arbitration is agreed to be The Hague in the Netherlands. The Cairn tax demand is on account of the alleged capital gains arising from the 2007 deal in the hands of Cairn UK Holdings, the erstwhile parent of Cairn India.

Also, the news report indicate that Vodafone intends to continue the process of international arbitration initiated under the India-Netherlands Bilateral Investment Treaty (BIT) to resolve the ongoing tax dispute against India. Whereas, the tax department intends to continue with its tax demand on the telecom major.

The Finance Minister in the Speech for Budget 2016-17, mentioned that in order to give an opportunity to the past cases, which are ongoing under the retrospective amendment, a one-time scheme of Dispute Resolution is proposed for them. Under this scheme, if the appellants agree to withdraw

the pending case, if any, lying in any Court or Tribunal or any proceeding for arbitration, mediation etc. under Bilateral Investment Protection Agreements (BIPA), they can settle the case by paying only the tax arrears in which case the liability of the interest and penalty shall be waived.

This means that companies like Vodafone Group Plc. and Cairn Plc will have the option of pursuing their disputes with the Indian government or go in for a one-time settlement.

Recent news reports indicate that the Finance Minister said the high-level committee announced in the July 2014 budget to look into such cases would now be headed by the Revenue Secretary as against a senior income tax department official.

Further, recent news reports indicate that the government has kept tax matters out of the ambit of a new draft Bilateral Investment Treaty to avoid arbitration with multinational companies that may receive tax notices from India, as it looks to prevent situations similar to the Vodafone and Cairn tax matters. One of the key proposals is that if India deems a certain dispute to be tax-related, companies at the receiving end cannot invoke the treaty in international arbitration to seek relief or compensation. The new treaty is expected to replace the existing bilateral investment protection and promotion agreements. The new treaty, once it is complete, is expected to be signed with all the countries with which India has bilateral investment treaties. Among some other conditions, the treaty will not apply to “any taxation measure, where a host State asserts as a defence that the conduct alleged to be a breach of its obligations under this treaty is a subject matter of taxation, any decision of the host State, whether before or after the commencement of arbitral proceedings, shall be non-justiciable and it shall not be open to any arbitration tribunal to review any such decision”.

Conclusion

Time again, the Government has reiterated its commitment to provide a stable and friendly tax regime to investors. If the Government wants to ‘walk the talk’, it needs to not only needs to refrain from introducing the retrospective amendments, which are of substantive nature, but also convert the retrospective amendments as prospective. Past has indicated that these retrospective amendments were not successful in bringing the desired tax collection, but it may have the effect of fearing away the foreign investment from India. Also, the amendments in the Act relating to international taxation should be in line with international best practices, which frown upon the

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retrospective amendments. The scope of tax under the Act and the various tax treaties should be in harmony, so that the intent of the Government to tax certain transactions is not defeated on the principle of treaty override the domestic tax provisions. It would be interesting to observe the developments in the provisions of the Act, Bilateral Investment Promotion and Protection Agreement (BIPA), etc. in relation to retrospective taxation.

Judicial precedents

Beneficial provisions of the tax treaty override the domestic tax provisions

- **CIT v. Siemens Aktiengesellschaft [2009] 310 ITR 320 (Bom)**

The Bombay High Court held that where provisions of DTAA entered into between India and other country are more beneficial to a non-resident assessee than provisions of the Act, the provisions of DTAA would prevail. The amounts received by assessee from Indian companies were in nature of 'royalty' within meaning of section 9(1)(vi), but under the DTAA between India and Germany, said amounts had to be considered as 'commercial profit' and as assessee had no PE in India, they could not be brought to tax in India

Beneficial provisions of the tax treaty override the amended domestic tax provisions relating to transfer of assets

- **Sanofi Pasteur Holding SA v. Department of Revenue [2013] 30 taxmann.com 222 (AP)**

In relation to the impact of the retrospective amendments, the Andhra Pradesh High Court held that the meaning and trajectory of the retrospective amendments to the Act must be identified by ascertaining, the legal meaning of the amendments, considered in the light of the provisions of the Act and the mischief that the amendments are intended to address. The retrospective amendments do not alter the provisions of the tax treaty and given the text of Section 90(2) of the Act, these amendments do not alter the taxability of the present transaction. Further, the retrospective amendments in Section 2(47), Section 4, Section 5 and Section 9 of the Act are not fortified by a non-obstante clause to override the provisions of the tax treaties.

Beneficial provisions of the tax treaty override the amended domestic tax provisions relating to royalty

- **Director of Income-tax v. Nokia Networks OY [2012] 25 taxmann.com 225 (Delhi)**

The taxpayer, a company incorporated in Finland, was a manufacturer of advanced telecommunication systems and equipment (GSM equipment) which are used in fixed and mobile phone networks. The taxpayer supplied both hardware and software to Indian Cellular Operators and Nokia India Private Limited (NIPL) for carrying installation work. The taxpayer had sold GSM equipment manufactured in Finland to Indian operators on a principal-to-principal basis, under independent buyer-seller arrangements. The Assessing Officer (AO) held that the 30 percent of the equipment revenues were attributed towards supply of software. It was taxed as 'royalty' under Section 9(1)(vi) of the Act and under the tax treaty.

The Delhi High Court held that the taxpayer has opted to be governed by the tax treaty and the language of the said tax treaty differs from the amended Section 9 of the Act. In the case of Siemens Aktiengesellschaft, the Bombay High Court has held that the amendments cannot be read into the tax treaty. On the wording of the tax treaty, the Delhi High Court in the case of Ericsson A.B.¹⁷ has already held that a copyrighted article does not fall within the purview of Royalty. The facts of this case were similar to the decision of Ericson A.B. and therefore ratio of the said decision would be squarely applied to this case.

- **DIT v. Shin Satellite Public Co. Ltd. [TS-555-ITAT-2014(Bang)]**

The Delhi High Court in the case of Shin Satellite Public Co. Ltd. held that payment for data transmission services through a transponder is not royalty under the India-Thailand and India-Netherlands tax treaties (tax treaties). A retrospective amendment introduced by the Finance Act, 2012 to the definition of 'royalty' will not affect Article 12 of the tax treaties. The High Court observed that no amendment to the Income-tax Act, 1961, whether retrospective or prospective could be read in a manner to extend its operation to the terms of an international treaty.

- **Bharti Airtel Ltd. v. ITO [2016] 67 taxmann.com 223 (Delhi - Trib.)**

The Delhi Tribunal held that the relevant payment in question is not 'Royalty'

¹⁷ DIT v. Ericsson A.B [2012] 343 ITR 370 (Delhi)

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as contemplated under the DTAA's. There would not be any change in above position, even subsequent to the retrospective amendments by adding Explanation 5 and 6 to Section 9(1)(vi) of the Act, since changes in domestic law cannot be read into the tax treaties as long as there is no change in the working of the tax treaties.

- **DIT v. New Skies Satellite BV [2016] 68 taxmann.com 8 (Delhi)**

Please refer above for this decision.

The amendment to the Act with retrospective effect indicates that the issue was debatable one, the penalty under Section 271(1)(c) cannot be levied.

- **CIT v. Yahoo India Pvt. Ltd. [2013] 33 taxmann.com 332 (Bombay)**

The AO levied penalty under Section 271(1)(c) of the Act on the ground that the payment made by the taxpayer to Yahoo Holdings (Hong Kong) Ltd. was without deduction of tax and it had been disallowed under the provisions of Section 40(a) of the Act. The tax department had filed appeal before the High Court wherein the tax department had sought to justify the disallowances relying on the Explanation 5 to Section 9 of the Act, duly amended by the Finance Act, 2012 with retrospective effect from 1 June 1976.

The High Court held that the Act has been amended with retrospective effect indicates that the issue was debatable and therefore, the penalty levied under Section 271(1)(c) of the Act was deleted.

Retrospective amendment in relation to royalty- short deduction of TDS should not attract disallowance under Section 40(a)(ia)

- **ACIT v. NGC Networks (I) Pvt. Ltd. [2014] 48 taxmann.com 149 (Mum)**

The taxpayer paid placement charges to cable operators for placing their channel on a particular frequency or bandwidth to maximise viewership and increase quality of the channel being aired. On such payments, the taxpayer deducted taxes at 2 per cent under Section 194C of the Act.

The Tribunal held that channel placement fee paid to cable operators/DTH providers cannot be regarded as royalty as it does not fall under the definition of 'royalty' under Explanation 2 to Section 9(1)(vi) of the Act. Further, with respect to the Explanation 6 inserted by the Finance Act, 2012, with effect from 1 July 1976, the same cannot be pressed into service for the purpose of disallowance under Section 40(a)(ia) of the Act because at the time when the taxpayer deducted the tax at source, the said explanation was

not on statute. In this regard, the Tribunal considered the decisions in the case of Channel Guide India Limited¹⁸ and Sterling Abrasives¹⁹, wherein it has been held that law cannot compel a taxpayer to do something, which is impossible to perform. Accordingly, in the instant case, the Tribunal held that when the taxpayer has deducted tax under Section 194C of the Act, which is a bona fide decision, keeping in view the nature of payments and facts of the case, it is not supposed to foresee the subsequent retrospective amendment in the statute to deduct tax at source under Section 194J of the Act. Further, the Tribunal also referred to the decision of the Calcutta High Court in the case of S.K Tekriwal²⁰, wherein it is held that if there is any shortfall due to difference of opinion, no disallowance under Section 40(a)(ia) can be made on account of shortfall in the deduction of taxes at source. The Tribunal also relied on the decision in case of SKOL Breweries²¹ (which in-turn relies on the decision of Sonata Information Technology Limited⁶) and held that Explanation 6 cannot be pressed into service, as the definition of 'royalty' for the purpose of Section 40 refers to 'royalty' as per Explanation 2 to Section 9(1)(vi) of the Act [and does not refer to Explanation 6 to Section 9(1)(vi)]. Accordingly, no disallowance should be made under Section 40(a)(ia) of the Act on account of placement charges paid by taxpayer to cable operators.

Supreme Court lays down important principles on retrospective taxation

• **CIT v. Vatika Township (P.) Ltd. [2014] 49 taxmann.com 249 (SC)**

In this case, the Supreme Court made certain observations relating to the general principles concerning retrospectivity:

- Unless a contrary intention appears, legislation is presumed not to be intended to have a retrospective operation. The principle of law i.e. *lex prospicit non respicit*²² should be applied.
- Our belief in the nature of the law is founded on the bedrock that every human being is entitled to arrange his affairs by relying on the existing law and should not find that his plans have been retrospectively upset.

¹⁸ Channel Guide India Limited v. ACIT [2012] 139 ITD 49 (Mum)

¹⁹ Sterling Abraive Ltd v. ACIT [2011] 140 TTJ 68 (Ahd)

²⁰ CIT v. S. K. Tekriwal [2014] 46 taxmann.com 444 (Cal)

²¹ SKOL Breweries Ltd v. ACIT [2013] 153 TTJ 257 (Mum)

²² Law looks forward not backward

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- In the case of *Phillips v. Eyre*²³, it was observed that a retrospective legislation is contrary to the general principle. The basis of the principle against retrospectivity is the principle of 'fairness', which must be the basis of every legal rule as was observed in *L'Office Cherifien des Phosphates*²⁴.
- Legislations, which modified accrued rights or which impose obligations or impose new duties or attach a new disability, have to be treated as prospective unless the legislative intent is clearly to give the enactment a retrospective effect.
- If legislation confers a benefit on some persons but without inflicting a corresponding detriment on some other person or on the public generally and where to confer such benefit appears to have been the legislators object, then the presumption would be that such legislation, giving it a purposive construction, would warrant it to be given a retrospective effect. This exactly is the justification to treat procedural provisions as retrospective.
- The rule against retrospective operation is a fundamental rule of law that no statute shall be construed to have a retrospective operation unless such a construction appears very clearly in the terms of the Act, or arises by necessary and distinct implication.
- The assessment creates a vested right and the taxpayer cannot be subjected to reassessment unless a provision to that effect inserted by amendment is either expressly or by necessary implication retrospective.

8.5 Foreign Tax Credit

The concept of Foreign Tax Credit

A tax credit is a relief in the total amount of the income-tax that a taxpayer owes to a State (for e.g. India), by virtue of the mechanism as provided in the relevant tax treaty or the domestic laws. When a credit is given by a state for the taxes paid in another state, it is termed as Foreign Tax Credit.

²³ *Phillips v. Eyre* [1870] LR 6 QB 1

²⁴ *L'Office Cherifien des Phosphates v. Yamashita-Shinnihon Steamship Co. Ltd* (1994) 1 AC 486

Bilateral relief – DTAA with other country

Under Section 90(1) of the Act, the Indian Government may enter into an agreement with a foreign Government, for the granting of relief; *inter alia*, in respect of income on which income-tax have been paid both in India and the foreign country, or income-tax chargeable under in India and the foreign country. Article 23 of the DTAAs generally provides for the bilateral relief from the double taxation.

Where such an agreement is entered into, then, in relation to the taxpayer to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that taxpayer.

The double taxation of the income could be because of either Economic Double Taxation or Jurisdictional Double Taxation. Economic Double Taxation takes place when the same income is taxed in the hands of more than one person (e.g., dividend). It is normally not addressed in the DTAAs. However, some DTAAs (not in case of India) provide for underlying tax credit, which is a form of relief for economic double taxation.

Jurisdictional Double Taxation takes place when the same income is taxed in the hands of the same person in more than one jurisdiction (e.g., foreign sourced dividend). Such taxation takes place since most countries follow the worldwide taxation approach i.e., all income of a resident of a country is taxed by that country, regardless of where it is earned. Where both the countries (i.e. the Source and Resident State) insist upon exercising their taxation right over the same income, double taxation results. DTAA typically contain a clause to resolve this through the FTC mechanism.

The relief from double taxation as provided in the tax treaties under Article 23 is either by exemption or by credit.

Relief by tax exemption method

Typically, under the principle of exemption, the State of Residence does not tax the income, which according to the DTAA may be taxed in Source State.

Relief by tax credit method

The credit method provides that the resident country would give credit for the taxes paid in the source country. As this Article provides for credit only for the taxes paid in the source country, but when the source country gives certain tax incentives, no credit would be available if no taxes have been actually paid by the taxpayer in the source country.

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Tax sparing consists of granting a tax credit in the resident country for the amount of tax that would have been payable in the source country had there been no reduction or exemption under the tax regime of the source country. The concept of tax sparing could also lead to double non-taxation. Some of the countries with whom India has this beneficial clause in the treaties are Cyprus, Mauritius, Singapore, etc. In case of some countries, this beneficial clause relates to them only as a Resident State for e.g. Australia, UK, etc.

Unilateral relief – No DTAA exists

Under section 91 of the Act, in respect of an Indian resident's income, which accrued or arose during a previous year outside India, and he has paid in any country with which there is no agreement under section 90, income-tax, by deduction or otherwise, he shall be entitled to the foreign tax credit. Such FTC shall be equal to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is the lower. Thus, Section 91 of the Act provides for a unilateral relief under the Indian domestic law.

Method of computation of relief under Section 91 is provided below:

- Ascertain the amount of income , which has been subject to double taxation;
- On such income, tax is calculated at the Indian rate of tax and the foreign rate of tax; and
- Relief is granted by allowing a deduction from the tax liability of an amount equal to the tax calculated at the Indian rate of tax or the amount of tax paid at the foreign rate of tax on the doubly taxed income, whichever is less.

Certain issues

A) Whether relief u/s 91 can be taken in respect of incomes not covered within the purview of the DTAAs?

- Section 91(1) grants relief for taxes paid in any “country with which there is no agreement under section 90 for the relief or avoidance of double taxation.”
- In the above situation, there is an agreement u/s 90, but it does not include certain income streams or certain scenarios.
- Although logically and based on a rational construction, it would seem

that relief u/s 91 should be allowed in such cases, the literal reading of the section 91 suggests otherwise.

Please refer to the decision in the case of Wipro Ltd., which is mentioned below.

B) Whether reliance can be placed upon the certificate issued by the revenue authorities of the Source State?

- This issue was considered by the Madras High Court in the case of *Lakshmi Textile Exporters Ltd.*²⁵. The Sri Lankan authorities held that the taxpayer had a permanent establishment (PE) in Sri Lanka.
- However, the Indian revenue authorities disputed the existence of the PE in Sri Lanka. The High Court interpreted Article 7 of the India-Sri Lanka tax treaty to prohibit India from taxing the profits attributable to the PE.
- In light of these facts, the High Court held that once the Sri Lankan Government had accepted that the taxpayer had a PE in Sri Lanka, the Indian revenue authorities could not dispute it.
- However, in actual practice, this judgment may not be accepted by the Indian revenue authorities and it may be highly disputed.
- The AAR in the case of Dynamic India Fund-I26, held that the capital gains arising to the Mauritius entity which holds a valid Tax Residency Certificate from the proposed sale of investment in India shall not be taxable under Article 13(4) of the India-Mauritius tax treaty. Further, the AAR has held that the tax department may consider the provisions of the General Anti-Avoidance Rule after the same comes into force.
- The Finance Act 2013 introduced a provision to clarify that in order to be eligible to claim relief under the tax treaty, the taxpayer shall be required to furnish such other information or document as may be prescribed. Subsequently, the CBDT had issued a notification amending the Income-tax Rules, 1962 (the Rules)²⁷ prescribing the additional information required to be furnished by non-residents along with the TRC. The details are required to be furnished in Form 10F.

²⁵ CIT v Lakshmi Textile Exporters Ltd (2000) 245 ITR 521 (Mad)

²⁶ Dynamic India Fund-I, In re vs. [2012] 23 taxmann.com 266 (AAR)

²⁷ Rule 21AB of the Income-tax Rules, 1962

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- C) Whether foreign tax credit can be claimed against MAT paid in India?
- One of the view is that the Minimum Alternate Tax (MAT) liability in India is not a crystallized one since a credit of the difference between the normal tax liability and the MAT liability can be taken.
 - It is only a collection mechanism by which the tax is required to be paid in the year and a credit for the same can be taken in the following years.
 - Thus, there is an opinion that the foreign tax credit may be taken only to the extent of the crystallized tax liability for the year i.e., the normal tax liability.
 - Other view is that the MAT liability is the amount of tax payable in India and the credit mechanism is a benefit, which is provided by the domestic law, and so it should not impact the credit of the foreign taxes paid.
 - The foreign taxes paid are similar to advance tax/ TDS paid by the taxpayer and the credit/deduction should be available in calculating the tax payable to the Indian authorities.

Please refer to the decision in the case of Subex Technology Ltd., which is mentioned below.

Judicial precedents

- **Wipro Ltd. V DCIT [2015] 62 taxmann.com 26 (Kar)**

The taxpayer, an Indian Company was engaged in the business of export of computer software including services for on-site development of software through its permanent establishments (PEs) in many countries such as USA, UK, Canada, Japan, Germany, etc. The taxpayer claimed credit for taxes paid outside India in relation to income eligible for deduction under section 10A. The Assessing Officer held that FTC claim cannot be allowed since the income was claimed as exempt under Section 10A. taxpayer also claimed relief for State Taxes paid in USA and Canada but same was also denied as the AO was of view that as per the tax treaty with USA and Canada, credit could only be allowed for Federal tax in USA and Canada. The taxpayer's claim was admissible only to the extent of deduction rejected under Section 10A.

The Karnataka High Court, inter alia, held as follows:

- In cases covered under section 90(1)(a)(ii) it is not a case of the

income being subjected to tax or the taxpayer has paid tax on the income. This applies to a case where the income of the taxpayer is chargeable under this Act as well as in the corresponding law in force in the other country. Though the income tax is chargeable under the Act, it is open to the Parliament to grant exemptions under the Act from payment of tax for any specified period.

- The income under section 10A is chargeable to tax under section 4 and is includible in the total income under section 5, but no tax is charged because of the exemption given under section 10A only for a period of 10 years. Merely because the exemption has been granted in respect of the taxability of the said source of income, it cannot be postulated that the taxpayer is not liable to tax. Therefore, the case falls under section 90(1)(a)(ii).
- Explanation (iv) to Section 91 defines the expression income tax in relation to any country to include any excess profit tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country. Section 91 provides relief from double taxation where no agreement relating to avoidance of double taxation exist with a foreign country and therefore, credit of states taxes shall be available.
- The income tax in relation to any country includes income tax paid in any part of the country or a local authority. The income tax in relation to any country includes income tax paid not only to the Federal Government of that country, but also any income tax charged by any part of that country meaning a State or a local authority, and the taxpayer would be entitled to the relief of double taxation benefit with respect to the latter payment also. Therefore, even in the absence of an agreement under section 90, by virtue of the statutory provision, the benefit conferred under section 91 is extended to the income tax paid in foreign jurisdictions.
- **DCIT v. Subex Technology Ltd. [2015] 63 taxmann.com 124 (Bang.)**

The taxpayer while computing tax liability under the provisions of section 115JB [Minimum Alternate Tax (MAT)] claimed relief under section 90 for foreign taxes paid. The tax department contended that taxes 115JB of the Act stood on a different footing than the regular tax computed under other

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provisions of the Act. Therefore, rebate for taxes paid in a foreign country could not be granted to the taxpayer.

The Bangalore Tribunal held that similar issue had come up before the Mumbai Tribunal in the case of L & T. Ltd.²⁸ In that case, the Mumbai Tribunal noted that the income on which tax has been paid abroad was included in 'book profit' for the purpose of Sec.115JA. It was held that once taxable income was determined either under the normal provisions of the Act or as per Section 115JB of the Act, subsequent portion relating to computation of the tax has to be governed by the normal provision of the Act. In that case, it also held that there was no provision in the Act, debarring granting of credit for tax paid abroad in case income is computed under Section 115JA of the Act. It was further held that the taxpayer could not be denied the set-off of tax relief against the tax liability determined under Section 115JA. Accordingly, it was held that credit under Section 90 of the Act, would be given on tax liability under MAT provisions of the Act.

8.6 Base Erosion and Profit Shifting

Countries around the world agree on the need to eliminate double taxation and the need to achieve this on the basis of agreed international rules that are clear and predictable, giving certainty to both governments and businesses. International tax law is therefore a key pillar in supporting the growth of the global economy.

The growing importance of the service component of the economy, and of digital products that often can be delivered over the internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. These developments have been exacerbated by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus providing MNEs with more confidence in taking aggressive tax positions.

Over time, the current rules have also revealed weaknesses that create opportunities for BEPS. These weaknesses put the existing consensus-based framework at risk.

On 5 October 2015, the OECD issued final report (the report) in connection with all its 15-point Action Plan to address BEPS, together with a plan for

²⁸ ACIT v. L & T Ltd. [ITA No. 4499/Mum/2008 dated 22-04-2009]

follow-up work and a timetable for implementation. Important issues from Indian tax perspective are listed as follows:

Action Plan 1 - Address the tax challenges of the digital economy

Please refer to 'Taxation of E-Commerce' for the tax issues related to the tax challenges of the digital economy.

Action Plan 2 - Neutralising the Effects of Hybrid Mismatch Arrangements

The objective of the Action Plan 2 is to develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. Another issue raising BEPS concerns is excessive deductible payments such as interest and other financial payments. The deductibility of interest expense can give rise to double non-taxation in both the inbound and outbound investment scenarios.

From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity that benefit from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. The result is that the interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed favourably or not at all at the level of the recipient, and sometimes the group as a whole may have little or no external debt. From an outbound perspective, a company may use debt to finance the production of exempt or deferred income, thereby claiming a current deduction for interest expense while deferring or exempting the related income.

It is pertinent to note that the General Anti Avoidance Rules (GAAR) provisions will help empower the AO to re-characterise equity as debt and vice versa, if the arrangement is treated as an impermissible avoidance arrangement. Further, it has been provided²⁹ that the GAAR provisions will apply even if such provisions are not beneficial to the taxpayer as compared to the tax treaty.

²⁹ Under Section 90 of the Act

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The Indian judicial precedent in this relation is as follows:

- **Zaheer Mauritius v. DIT International Taxation [2015] 230 Taxman 342 (Del)**

In 2012, the AAR³⁰ in the taxpayer's case observed that the calculation of the purchase price of Compulsorily Convertible Debentures (CCDs) is almost entirely dependent on the period of holding of the investment. Accordingly, the AAR held that income from sale of CCDs by the applicant is taxable in India as 'interest' under Section 2(28A) of the Act and Article 11 of the India-Mauritius tax treaty. Further, the AAR considered the Indian holding company and the Indian subsidiary company as one and treated the entire transaction as a sham, and therefore held that sale of Indian company shares by a Mauritius company is not exempt under the tax treaty. In this case, the High Court has set aside the AAR ruling.

The High Court has relied on the RBI Circular, which holds that an instrument, which is fully and mandatorily convertible into equity shares within a specified time would be reckoned as part of equity under the FDI Policy. Based on the perusal of Securities Subscription Agreement (SSA), Shareholder's Agreement (SHA) with Vatika and the JV Company, and other relevant documents, the High Court held that the Indian JV for real estate development was a genuine commercial venture. The legal nature of the instrument of a CCD would not be ignored nor would the corporate veil be lifted to treat the JV and Vatika as a single entity. Any amount payable by the issuer of debentures to its holder would usually be interest in the hands of the holder. However, gains arising from the sale of capital assets would not be in the nature of interest. Under normal circumstances, the gains arising from transfer of a debenture, which is a capital asset in the hands of the transferor, in favour of a third party, would be capital gains and not interest. Article 10 of the SHA did not indicate that the taxpayer was only entitled to a fixed return on the investments made by it in the equity and CCDs issued by the JV Company. Article 10(1) of the SHA entitles Vatika to call upon the taxpayer to sell its investment at a price to be computed in the manner as provided in the clause. If this option was exercised after the expiry of three years from the first closing date, the price to be computed would also include a component of 'equity payment' which was defined to mean an amount equal to 10 per cent of the project value and consequently, a portion of the

³⁰ Z (A.A.R. No. 1048 of 2011)

assets of the JV company. Merely because an investment agreement provides for exit options to an investor, the nature of the investment made would not change. The SHA indicates that it was a joint venture agreement. Although, the SHA enables the taxpayer to exit the investment by receiving a minimum return, the same cannot mean that the CCDs were fixed return instruments, since the taxpayer also had the option to continue with its investment as an equity shareholder of the JV Company. Based on the decision in the case of Vodafone International Holdings BV³¹, the High Court applied the 'look at test' to ascertain the true legal nature of the equity shares and CCDs, and held that the gains arising from their sale would be exempt from capital gains tax under Article 13(4) of the tax treaty.

In the above case, the capital gains on transfer of CCDs are not taxable in India. In addition, the capital gains on transfer of such CCDs is taxed at nil rate in Mauritius. This leads to double non-taxation of the gains arising from transfer of such CCDs.

In the above case, the AAR held that the calculation of the purchase price of CCDs is almost entirely dependent on the period of holding of the investment. Accordingly, the income from sale of CCDs by the applicant is taxable in India as 'interest' under Section 2(28A) of the Act. Similarly, once the GAAR provisions come into effect, the AO can characterize the accretion in the value of debentures as taxable interest.

The SLP has been granted by the Apex Court in case **(2016) 76 taxmann.com 85 (SC)**.

Action Plan 3 - Designing Effective Controlled Foreign Company Rules

The report sets out recommendations in the form of building blocks of effective Controlled Foreign Company (CFC) rules, while recognising that the policy objectives of these rules vary among jurisdictions. The work emphasises that CFC rules have a continuing, important role in tackling BEPS, as a backstop to transfer pricing and other rules.

At present India does not have CFC regulations. In the past, the Finance Minister had released the draft Direct Taxes Code, 2013 (DTC 2013) for public discussion/comments. As per the DTC 2013, beneficial provisions of the tax treaty may not apply where, *inter alia*, CFC related provisions are invoked. In case the proposed CFC Rules are intended to be incorporated in

³¹ Vodafone International Holdings BV v. UOI and Anr. [2012] 6 SCC 613 (SC)

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the Act, the Indian Government may consider to bring them in line with the BEPS Action Plan.

Action Plan 4 - Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

BEPS risk arises, inter alia, when a group places higher levels of third party debt in high tax countries or uses intragroup loans to generate interest deductions in excess of the group's actual third party interest expense. The report designs rules to prevent base erosion by interest expense.

Presently, the thin capitalization rules are directly incorporated in the provisions of the Act. However, excess deduction of interest is checked through the Indian TP regulations. The thin capitalization rules are covered within the ambit of the proposed GAAR, which shall be effective in a couple of years.

The Indian judicial precedent in this relation is as follows:

- **India Debt Management Pvt. Ltd. v. DCIT [IT(TP)A No. 7518/Mum/2014] – Taxsutra.com**

The taxpayer is a non-banking finance company (NBFC) registered in India and a subsidiary of Mauritius Debt Management Ltd., which holds 75 per cent of equity share capital of the taxpayer. The taxpayer is engaged in the business of identifying investment opportunities in financially distressed companies which otherwise have an inherently viable business proposition and had a low credit rating of BBB(-). These investments were funded through intra-group financing, wherein taxpayer raises money through debt instruments i.e. CCDs from group companies. The average interest rate on the above CCDs issued by the taxpayer was determined at the rate of 11.30 per cent.

In the Transfer Pricing Study report (TP study), in order to benchmark the Arm's Length Price (ALP) of the interest rate on the CCDs, the taxpayer adopted Comparable Uncontrolled Price (CUP) method as Most Appropriate Method (MAM). Since there was no internal CUP available, the taxpayer analysed the External Market Data using Thomson Reuters' DealScan and Bloomberg Database in order to find external CUP. As the taxpayer had issued CCDs in terms of INR and interest was also payable in terms of INR, since India being the borrowing region, no comparables were found in the search for Indian region of INR denomination for loans/bonds, and therefore, the search was expanded to include other geographical regions or

currencies. Based on this search, after carrying out certain adjustments for differences in comparables risk profiles, 14 comparable transactions were selected with arm's length interest rate of 14.50 per cent as against interest rate of 11.30 per cent paid by the taxpayer. Further, in its TP study, in order to justify its interest payment of 11.30 per cent, the taxpayer assimilated information on interest rates quoted by various public sector banks on their websites, for loans taken from lenders in the Indian market, whereby the average rate offered to BBB rated entities or below with a loan amount of more than 10 crores was reflected at 14.96 per cent as on May 2013. Since pre-dated data in the websites was not available, the taxpayer made a tenor adjustment for a time period difference, by considering the relevant difference between the Prime Lending Rate prevalent during the Financial Year (FY) 2009-10 and arrived at an average interest rate of 12.13 per cent. Therefore, the taxpayer contended that its average interest rate of 11.30 per cent is at arm's length.

During the assessment proceedings, the Transfer Pricing Officer (TPO) rejected the entire methodology adopted by the taxpayer, on the ground that it did not pointed out anywhere in its TP study, whether it has taken the taxpayer or the AE as a 'tested party'. The DRP also observed that taxpayer's TP study was very sketchy to prove that international transactions were at arm's length, and even Functions, Assets, and Risks analysis had not been carried out.

The Tribunal, inter alia, held that product comparability is the 'key factor' under CUP method unlike the other methods like CPM, RPM or TNMM wherein financial indicators like markup on costs, gross margin or net profit is tested with an appropriate base. Hence, the Tribunal observed that under these other methods, the choice of the 'tested party' becomes far more imperative which is envisaged by para 5.3.3 of the UN TP Manual and para 3.18 of the OECD guidelines, with no such reference of the tested party under CUP method. The transaction to be benchmarked was interest payment by the taxpayer to its AE i.e. transaction undertaken by the taxpayer and not vice-versa. It observed that if the transaction was undertaken by AE, then similar transaction by AE with the third party or independent similar transaction in the place of AE could have been analysed to arrive at an ALP.

Regarding USD Corporate Bond Rate and LIBOR interest rate based on ECBs endorsed by the department for arriving at the ALP interest rate, the Tribunal observed as under:

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- As the tested transaction was in INR denominated debt, the interest rate must necessarily be based on economic, and market factors affecting Indian currency and data available for debt issuances in India or INR denominated rather than foreign currency rate or external data. The base rate on which interest rate depends is directly related to the currency or denomination of issuance, and therefore, it should be taken into account according to the market conditions prevalent in the country of such currency, here in this case India.
- The market conditions capable of capturing best of the rates did not depend on any place but rather on currency concern as the supply and demand of funds is in a specific currency. Therefore, the cost of borrowing funds denominated in INR or lending rates based on INR loans/debt instrument issuances was more reliable and ideal base for benchmarking similar transactions undertaken by the companies or entities with similar ratings.
- The TPO/DRP committed a fallacy, by considering the AE as a 'tested party' and by relying upon USD Corporate Bond Rates to benchmark the ALP of the interest rate because the interest rates for bonds or loan has to be seen from the point of view of borrowers creditworthiness and not the lender's creditworthiness. Thus, the Tribunal held that the entire approach of the TPO/DRP in applying USD Corporate bond rates to benchmark the interest transaction in a blanket manner is not correct.

The Tribunal, relying on the decision of Delhi High Court in the case of Cotton Naturals India (P) Ltd.³², wherein it was held that the arm's length interest rate should be computed based on market determined interest rate applicable to currency in which loan has to be repaid, held that the arm's length interest rate should be based on INR in which CCDs has been issued and the currency in which interest is being paid and not on any foreign currency lending rate.

Regarding the benchmarking analysis done by the taxpayer, the Tribunal held as under:

- The search based on external data using Thomson Reuters' Deal

³² CIT v. Cotton Naturals India (P) Ltd [2015] 55 Taxmann.com 523 (Delhi)

Scan and Bloomberg Database is not correct as there was no INR denominated debt issuance available on such databases and in the absence of such data, the taxpayer made huge adjustments on account of country risk, currency risk and tenor risk.

- The search undertaken for comparable debt issuances in BSE used data for the year 2013 with minor tenor adjustment in the absence of such data for FY 2009-10 to arrive at a mean rate of 15.01 per cent. The Tribunal held that if such a data were not available, then such a minor tenor adjustment for considering time period can be made to eliminate the material effect under CUP, if it has been made quite accurately taking into account the material factors relating to time of the transaction affecting the price, although a high degree of comparability is required under CUP method.
- As regards the 2 comparable transactions for the year 2009 wherein for credit rating of AA or AA(+) Enterprises, the interest rate per annum is between 11 per cent to 12 per cent for a tenor of 60 months, then in the case of the taxpayer with BBB(-) credit rating, 11.30 per cent interest paid to its AE is much within the arm's length rate.

Based on the above, the Tribunal held that 11.30 per cent interest rate is at ALP and thus, deleted the TP adjustment.

In a nutshell, the Tribunal held that the interest rate on borrowings should be market determined and should be applicable to the currency in which loan is borrowed/repaid, to be considered at arm's length.

- **PMP Auto Components P. Ltd. v. DCIT [TS-263-ITAT-2014(Mum)-TP]**

The assessee is engaged in the business of manufacturing and marketing auto components original equipment manufacturers. During the Assessment Year (AY) 2009-10, the assessee had advanced loan to its wholly owned subsidiary PMP Mauritius. It had agreed for a moratorium of one year after which it would charge interest. The assessee had also advanced loan to PMP Bakon, Hungary, another subsidiary, where an interest rate of 8 per cent was being charged. The Transfer Pricing Officer (TPO) proposed a Transfer Pricing (TP) adjustment by adopting an interest rate at 15 per cent on the basis of the bank lending rate of 12 per cent plus markup of 3 per cent on account of the risk in giving the loan without any security, for both the

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loans. The Dispute Resolution Panel (DRP) upheld the adjustment made by the TPO. The TPO also made addition on account of notional interest, on the share application money remitted by the assessee towards investment in equity shares of its subsidiary PMP Mauritius, as the shares were allotted almost after a period of one year.

In relation to the addition of notional interest on account of loans given to the Associated Enterprises (AE), the Tribunal held as follows:

- On the issue of prime lending rate or LIBOR rate to be taken as arm's length interest rate, the Tribunal directed the Assessing Officer/TPO to consider LIBOR plus 2 per cent after placing reliance on the Tribunal ruling in Aurionpro Solutions Ltd.³³
- The Tribunal dismissed the contention of the assessee due to moratorium of payment of interest, no interest was charged to the Mauritius based AE.
- When the transaction between the assessee and the AE falls within the ambit of international transaction as per the provisions of section 92B, then the ALP has to be determined by the Comparable Uncontrolled Price (CUP).
- On the assessee's contentions on Article 11, The Tribunal held that the provisions of Article 11 defer the taxability of interest arising but not received, and it is taxable when received. In the present case the assessee did not even admit the arising of interest on the loan and its accrual to the assessee; The Tribunal held that the provisions of Article 11 of Indo-Mauritius treaty cannot be considered in the present case.

On the issue related to notional interest on share application money, the Tribunal held that capital contribution could be treated as interest free loan for the period of inordinate delay, and not the entire period till the actual allotment of shares.

- **Hinduja Global Solutions Limited**

The Mumbai Tribunal in the case of Hinduja Global Solutions Limited³⁴ (the taxpayer) has, inter alia, held that in respect of loan given to Associated

³³ Aurionpro Solutions Ltd. vs. ACIT [TS-75-ITAT-2013(Mum)-TP]

³⁴ Hinduja Global Solutions Limited v. ACIT (ITA No. 254/MUM/2013) – Taxsutra.com

Enterprise (AE) in USD, London Interbank Offered Rate (LIBOR) rate be adopted as the arm's length rate of interest. Since, interest rate charged by the taxpayer from its AE was higher than LIBOR, no transfer pricing adjustment was warranted.

Action Plan 5 - Countering harmful tax practices more effectively, taking into account transparency and substance

The objective of the Action Plan 5 is to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime and recommends "nexus approach". The nexus approach was developed in the context of IP regimes, and it allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income.

OECD states that in respect of substantial activity, the 16 IP regimes reviewed were considered inconsistent, either in whole or in part, with the nexus approach as described in the BEPS report. Countries should now proceed with a review of possible amendments to their regimes.

Recently, India has either entered into or revised the tax treaty with other countries/jurisdictions, to include the Article for 'Exchange of Information', 'Assistance in collection of taxes, etc. These measures assist in improving transparency and counter harmful tax practice effectively.

Presently, there are no IP regimes in India, which may fall under the scope of BEPS. However, the existing IP structures that are located in the preferential regime of the group may be examined, to evaluate whether they are in line with the recommendations proposed in this report. As regards to Indian non-IP regimes, the report evaluated four such regimes (viz. certain income of offshore banking units and international financial service centres, newly established units in a Special Economic Zone, a special provision for taxation of shipping companies and taxation of insurance businesses) and concluded that none of these regimes were considered as harmful from a BEPS perspective.

Action 6 - Preventing the granting of treaty benefits in inappropriate circumstances

Action 6 of the BEPS Project identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. As per

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the BEPS report, taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries have therefore agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping. These new treaty anti-abuse rules first address treaty shopping, which involves strategies including a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, etc.

The recent trend has been that almost all the tax treaties entered by the Indian Government in the last decade include LOB clause. This is also in line with India's commitment at G20 platform to inch towards implementation of BEPS initiative.

On 10 May 2016, India and Mauritius has signed a Protocol amending the India-Mauritius tax treaty. A Limitation of Benefit (LOB) clause has been introduced which provides that a resident of a State shall not be entitled to the benefits of 50 per cent of the tax rate applicable in transition period (1 April 2017 to 31 March 2019) if its affairs were arranged with the primary purpose to take advantage of such benefits. A shell/conduit company, which claims to be a resident of a State, shall not be entitled to the benefits of the transition period. As per a Press Release, the Protocol will tackle the long pending issues of treaty abuse and round tripping of funds attributed to the India-Mauritius tax treaty, curb revenue loss, prevent double non-taxation, streamline the flow of investment and stimulate the flow of exchange of information between India and Mauritius.

Also, the Mauritius Government has taken active steps to reduce the tax treaty abuse, *inter-alia*, the Mauritian Income Tax law has been amended to enhance procedures relating to issue of Tax Residency Certificate.

Tax Treaty benefits were granted

- **Union of India v. Azadi Bachao Andolan [2003] 132 Taxman 373 (SC)**

In relation to treaty shopping, the Supreme Court has observed that there are many principles in fiscal economy, which though at first blush might appear to be evil, but are tolerated, in a developing economy, in the interest of long-term development, for e.g. treaty shopping. Whether it should continue, and, if so, for how long, is a matter, which is best left to the discretion of the executive, as it is dependent upon several economic and political

considerations. This court cannot judge the legality of treaty shopping merely because one section of thought considers it improper.

- **Sanofi Pasteur Holding SA v. Dept. of Revenue [2013] 30 taxmann.com 222 (AP)**

The Andhra Pradesh High Court held that a special purpose investment company is an independent corporate entity. It has a commercial substance and purpose (FDI in Indian company). Further, it is not required to lift the corporate veil of such investment company and tax the capital gains in the hands of shareholders of the investment company. Capital gains arising from transfer of shares of a French sub-holding company are taxable in France in terms of Article 14(5) of the India-France tax treaty (tax treaty). The retrospective amendments to the Income-tax Act, 1961 (vide the Finance Act, 2012) have no impact on interpretation of tax treaty.

- **ITO v. MUR Shipping DMC Co., UAE [2015] 62 taxmann.com 319 (Rajkot - Trib.)**

The Rajkot Tribunal held that the benefit of the India-UAE tax treaty cannot be denied to the foreign shipping company by applying LOB provisions, since such a company has bonafide business activities in the UAE. The Tribunal held that LOB provisions under the tax treaty would be applicable only when the main purpose or one of the main purposes of the creation of an entity was to obtain benefits of the tax treaty, which would otherwise not be available.

Tax Treaty benefits were not granted

- **X Ltd., In re [1996] 86 Taxman 252 (AAR-DELHI)**

The applicant-companies, which were fully owned subsidiaries of a British company, had invested in the shares of an Indian bank. The AAR held that the Place of Effective Management (POEM) of the applicant-companies was situated in Mauritius. Consequently, under Article 4(1) read with Article 4(3), of India-Mauritius Tax Treaty (the tax treaty), the applicants were residents of Mauritius for purposes of the tax treaty. All the shares of the applicant companies were held by the British Bank and consequently, the entire funds of the applicant-company by way of share capital had been contributed by that bank. Accordingly, the AAR held that it was the British Bank, and not the applicants, which was the real and beneficial owner of the assets of the applicant companies including the shares in the Indian Bank. Therefore, the applicant-companies were not the beneficial owners of the dividends payable

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on their shares in the Indian Bank and thus the dividends received by them from the Indian Bank were liable to be taxed at 15 per cent of the gross amount thereof and not at 5 per cent as claimed.

Action Plan – 7 - Preventing the Artificial Avoidance of Permanent Establishment Status

The Action Plan - 7 calls for a review of the definition of the PE in a tax treaty, to prevent the use of certain common tax avoidance strategies that are currently used to circumvent the existing PE definition. As an example, the arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors, by commissionaire arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country. This Action Plan aims to ensure that a business' core activities should not inappropriately benefit from the exception for preparatory and auxiliary activities, and that the PE status should no longer be circumvented via the use of commissionaires or similar structures, or via the fragmentation of activities among different group entities. BEPS report includes the changes that will be made to the definition of PE in Article 5 of the OECD Model Tax Convention.

Preparatory and auxiliary activities

- **Consulting Engineering Corporation v. JDIT (I.T.A.No.1597/Del/2009; Assessment Year: 2003-04)**

In this case, the taxpayer, a US company, reduced their cost of services and other expenditure by assigning and appointing highly technical and materially skilled professionals to discharge its main function in India at low cost. The Delhi Tribunal held that the activities carried out by the Indian branch office was not of preparatory or auxiliary nature under the India-USA tax treaty. The Indian branch represented a fixed place of business through which substantial work was carried out by the taxpayer and therefore, it constitutes a Permanent Establishment (PE) of the taxpayer in India.

- **DIT v. Morgan Stanely and Co. Inc. [2007] 292 ITR 416 (SC)**

In relation to the preparatory and auxiliary activities, the Supreme Court has observed that under Article 5(3)(e) of India-USA tax treaty, activities, which are preparatory or auxiliary in character and are carried out at a fixed place of business, will not constitute a PE. Article 5(3) commences with a non-obstante clause, and it states that notwithstanding what is stated in Article 5(1) or under Article 5(2), the term PE shall not include maintenance of a

fixed place of business solely for advertisement, scientific research or for activities, which are preparatory or auxiliary in character. In the present case, the above-mentioned back office functions proposed to be performed by MSAS in India falls under Article 5(3)(e) of the DTAA. Therefore, MSAS would not constitute a fixed place PE under Article 5(1) of the DTAA as regards its back office operations.

Composite contracts

Composite contracts may or may not be considered as being fragmented either among different group entities or within the same company. The issue of taxability of offshore supply and services has been a matter of debate before the Courts. Certain case laws on the issue of composite contracts are mentioned as follows:

- Ishikawajima Harima Heavy Industries Ltd. v. DIT [2007] 158 TAXMAN 259 (SC)
- Global Industries Asia Pacific Pte. Ltd. v. DIT [2012] 343 ITR 253 (AAR)
- IHI Corporation v. ADIT [2016] 156 ITD 677 (Mum)

Please refer to synopsis of some important judgments and advance rulings for the above decision.

- **Linde AG, Linde Engineering Division v. DDIT [2014] 44 taxmann.com 244 (Del)**

The Delhi High Court in the case of Linde AG, Linde Engineering Division and Anr.1 (the taxpayer), inter alia, dealt with issues relating to the taxability of offshore and onshore supply and services under the composite contract and consortium.

In relation to divisibility of the contract, the High Court relying on the Supreme Court's decision in the case of Ishikawajima-Harima Heavy Industries³⁵ held it was held that it would not be appropriate to consider the contract as a composite one for the purposes of imposition of tax under the Act. The subject matter of taxation was not the contract between the parties but the income that the taxpayer derived from the contract. The principle of apportionment of income on the basis of territorial nexus is now well accepted. Explanation 1(a) to Section 9(1)(i) of the Act also specifies that

³⁵ Ishikawajima-Harima Heavy Industries v. DIT [2007] 288 ITR 408 (SC)

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only that part of income, which is attributable to operations in India, would be deemed to accrue or arise in India.

In relation to the taxability of the offshore services under the Act, the High Court held that if it is accepted that the services provided by the taxpayer relating to design and engineering are inextricably linked with the manufacture and fabrication of the material and equipment to be supplied overseas and form an integral part of the said supplies, then such services would not be taxable under Section 9(1)(vii) of the Act. Consideration for such services would not be considered as Fees for Technical Services (FTS) for the purposes of Section 9(1)(vii) of the Act³⁶. It was clarified that in order to fall outside the scope of Section 9(1)(vii) of the Act, the link between the supply of equipment and services must be so strong and interlinked that the services in question are not capable of being considered as services on a standalone basis and are therefore subsumed as a part of the supplies.

In relation to the taxability of the offshore services under the India-Germany tax treaty (tax treaty), the High Court held that the source of FTS was in India and, therefore, by virtue Article 12(1) and (2) of the tax treaty read with Section 9(1)(vii) of the Act, the same would be liable to be taxed in India provided the said fees was not attributable to taxpayer's PE in India. In the event such fees was attributable to PE in India, by virtue of Article 12(5) of the tax treaty, Article 7 of the tax treaty would be applicable and the income arising from provision of services would be liable to tax in India as business profits.

In relation to the onshore supply and services, the High Court held that there can be no dispute that the taxpayer would be liable to pay tax on the component of income included in the amounts received by it on account of onshore supply and services, viz.,: supervision during the pre-commissioning construction, post commissioning services and supplies, training and other items of work/activities to be performed in India.

The SLP was dismissed **(2016) 242 Taxman 371 (SC)** as it was withdrawn in view of Circular No. 7/2016, dated 7-3-2016 against High Court's ruling that where non-resident companies together as consortium took up turnkey contract from an Indian company, in absence of sufficient degree of joint action between consortium members in either execution or management of project, consortium would not be deemed as an AOP for purposes of Income-tax Act

³⁶ Rotem Company [2005] 279 ITR 165 (AAR)

- **DIT v. Nokia Networks OY [2012] 25 taxmann.com 225 (Del)**

In this case, the taxpayer, a company incorporated in Finland, was a manufacturer of advanced telecommunication systems and equipment (GSM equipment) which are used in fixed and mobile phone networks. The taxpayer entered into agreements with various Cellular Operators and made contracts with them for Overall Agreement, Supply Agreement and Installation Agreement.

In relation to the taxation of the offshore supply, the High Court of Delhi held that the supply contract was different from other contracts. Further, the supply was made from foreign country and the existence of this equipment was at the taxpayer's factory before dispatch of the equipment as per the Supply Agreement. Accordingly, relying on the decision of Ericsson A.B., these contracts cannot be treated as composite contracts. If the Supply Agreement is taken as standalone Agreement, the facts of the present case indicates that such supplies under this agreement were executed in overseas. The property in goods had passed on to the buyer outside India where the equipment was manufactured. Therefore, as per the Supreme Court's decision in the case of Ishikawajima Harima Heavy Industries Ltd, said agreement would not be taxable in India. If the Supply Agreement is taken as standalone Agreement, the facts of the present case indicates that such supplies under this agreement were executed in overseas. The property in goods had passed on to the buyer outside India where the equipment was manufactured. Therefore, as per the Supreme Court's decision in the case of Ishikawajima Harima Heavy Industries Ltd, said agreement would not be taxable in India. Section 19 of the Sale of Goods Act makes it clear that property in goods passes when the parties intend it to pass. In the present case, the intention of the parties is manifested in Article 13 of the supply contract and the provisions of Article 15 of supply contract in no manner militate against such intention. The contract was signed in India, however, that may not be relevant to determine the taxability of such income in view of the decision of the Andhra Pradesh High Court in the case of Skoda Export³⁷. The places of negotiation, the place of signing of agreement or formal acceptance thereof or overall responsibility of the taxpayer are irrelevant circumstances. Since the transaction relates to the sale of goods, the relevant factor and determinative factor would be as to where the property in

³⁷ Skoda Export v. SCIT [1983] 143 ITR 452 (AP)

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the goods passes. The property in the goods is passed outside India and therefore, the sale of equipment has taken place outside India. Further, in case of one composite contract, supply has to be segregated from the installation and only then, the question of apportionment arises under the Act.

- **Alstom Transport SA, In re [2012] 22 taxmann.com 304 (AAR)**

In relation to taxability of offshore transaction, the AAR held that the tender floated was a composite tender. A contract for the installation and commissioning of a project cannot be split up into separate parts as consisting of independent supply or sale of goods and for installation at the work site, leading to the commissioning. A contract has to be read as a whole in the context of the purpose for which it is entered into. Relying on the decision in the case of Linde A. G.³⁸ and in Roxar Maximum Reservoir Performance WLL³⁹, the AAR observed that the aforementioned contracts should be read as a whole in the context of the object sought to be achieved and they cannot be split up into different parts for the purpose of taxation. The AAR relied on the decision of Vodafone and held that the Supreme Court in Vodafone International Holdings B. V. has not overruled Ishikawajima–Harima Heavy Industries Limited or dealt with a situation similar to the one that was available in Ishikawajima–Harima Heavy Industries Limited. However, the clear disapproval of the dissecting approach in Vodafone could not be ignored or bypassed by this Authority or any Court.

- **Roxar Maximum Reservoir Performance WLL, In re [2012] 21 taxmann.com 128 (AAR)**

The AAR held that payments received under a composite contract for supply and installation/commissioning of equipments cannot be segregated, and hence such payments are liable to tax in India. The two-judge bench decision of the Supreme Court in the case of Ishikawajima-Harima Heavy Industries Ltd. adopting a dissecting approach could not be followed in view of the three-judge bench decision in the case of Vodafone International Holdings BV, wherein the principle is laid down that what is needed, is to consider the transaction in its entirety and look at the transaction as a whole and not adopt a dissecting approach.

³⁸ Linde A.G. (AAR No. 962 of 2010) (AAR)

³⁹ Roxar Maximum Reservoir Performance WLL (AAR No. 977 of 2010) (AAR)

Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation

Low-Value Adding Intra Group services (LVIGS) - Classification of services and appropriate mark-up

OECD BEPS Action 8-10 deals with low value-adding intra-group services (LVIGS) and one of the criteria for the service to be considered as LVIGS is that it should not form part of the core business of the MNE group. Further, if the services are classified as LVIGS, a mark-up of 5 percent of the relevant cost for the LVIGS is prescribed to justify the arm's length price. In this case, the challenge may be two-fold.

Firstly, the challenge may be whether the services provided by one of the entity in an MNE Group pertains to the core business. To illustrate this, let us take an example, assuming the primary business of the MNE Group (say SM Group) is manufacturing of shoes and it has an entity providing only accounting services (say entity AS). In this case, accounting service is the principal business of the said entity, however, at the group level, these service does not relate to the core business of the group i.e. shoe manufacturing. Thus, accounting service will be considered as LVIGS at the entity level and not at the group level. This argument may or may not be acceptable to the tax authorities which do not subscribe to or adopt the guidance provided in the Action Plan 8-10 pertaining to LVIGS.

Secondly, the mark-up suggested in the aforesaid guidance may be challenged by the tax authorities which do not adopt the prescribed guidelines for LVIGS. Say in case of India, the aforesaid entity AS engaged in providing accounting services may find it difficult to justify the said low mark-up charged for its services. The tax authorities will claim to apply a higher mark-up to remunerate the said services and this may lead to protracted litigation for AS entity in India.

Action 13 Transfer Pricing Documentation and Country-by-Country Reporting

India, has introduced CbyC reporting vide Finance Act 2016, which is essentially in line with OECD BEPS Action 13. It specified that CbyC reporting shall apply for an international group having Indian parent for FY 2016-17 if the consolidated revenue of the international group in previous year i.e. FY 2015-16 exceeds EUR750 million (the international consensus threshold). However, no specific threshold was specified for maintenance of the Master File.

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Different Master File regulations in different jurisdictions

In the context of an MNE Group, it would be imperative that the requirements for master file prescribed in various jurisdictions in which the MNE Group operates, is given due consideration. Different compliance requirements in different jurisdictions may have significant implications in terms of information dissemination, efforts and resources required to ensure compliance. Let us look at an example to understand this further:

There is no requirement to prepare and furnish a Master File in United States of America. In case of a US headquartered MNE Group having operations outside the U.S. say Australia, Netherlands, Poland etc. (*where preparing and filing of Master File is mandatory*). In this scenario, though the US parent entity is not obligated to prepare and furnish a Master File with US tax authorities, it would be required to prepare a Master file to enable its Group entities to furnish the same with their respective tax authorities.

Thus it can be seen that though one entity may not be obligated by its domestic regulations to prepare a Master File, it will be saddled with the burden to prepare the same to enable its Group entities to furnish it with their tax authorities.

BASE EROSION PROFIT SHIFTING

9.1 Base Erosion Profit Shifting – An introduction

International tax issues have never been as high on the political agenda as they are today. The integration of national economies and markets has increased substantially in recent years. This has put a strain on the international tax framework, which was designed more than a century ago. Incongruities in the current international tax rules could result in profits disappearing for tax purposes, or allow the shifting of profits to no or low-tax locations where the business has little or no economic activity. These activities are referred to as Base Erosion and Profit Shifting (BEPS). Apart from some cases of blatant abuses, the issues lie with the tax rules themselves.

BEPS results in a loss of revenue for governments that could otherwise be invested to support resilient and balanced growth. Research undertaken since 2013 confirms the potential magnitude of the BEPS problem, with estimates indicating annual losses of anywhere from 4 to 10 per cent of global corporate income tax revenues, i.e. USD 100 to 240 billion annually. In developing countries, where reliance on corporate tax as a source of revenue is generally higher than in developed countries, the potential impacts are particularly stark.

Since the current rules revealed weaknesses, it naturally created opportunities for BEPS, thus requiring a bold move by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created. In September 2013, G20 Leaders endorsed the ambitious and comprehensive Action Plan on BEPS.

The level of interest and participation in the work was unprecedented with more than 60 countries¹ directly involved in the technical groups and many

¹ Albania, Argentina, Australia, Austria, Azerbaijan, Bangladesh, Belgium, Brazil, Canada, Chile, Colombia, Costa Rica, People's Republic of China, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Greece,

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more participating in shaping the outcomes through regional structured dialogues. Regional tax organisations such as the African Tax Administration Forum (ATAF), Centre de rencontre des administrations fiscales (CREDAF) and the Centro Interamericano de Administraciones Tributarias (CIAT) joined international organisations like the International Monetary Fund (IMF), the World Bank (WB) and the United Nations (UN), in contributing to the work.

The Action Plan on BEPS (Organisation for Economic Co-operation and Development (OECD), 2013) identified 15 action plans, along three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency, as well as certainty for businesses that do not take aggressive positions.

Out of a shared desire to address BEPS concerns, there is agreement on a comprehensive package of measures which are designed to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The goal is to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms.

For the first time all OECD and G20 countries have worked together on an equal footing to design common responses to international tax challenges.

Further, there has been unprecedented participation by developing countries in the development of commonly-agreed international tax standards. The fact that so many countries have participated in the work and cooperated in the development of changes to the international tax environment is in itself a significant achievement of the Project. Working together within OECD/G20 Inclusive Framework on BEPS, over 135 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.

OECD on 5 October 2015 issued final reports in connection with all its Action

Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kenya, Korea, Latvia, Lithuania, Luxembourg, Malaysia, Mexico, Morocco, Netherlands, New Zealand, Nigeria, Norway, Peru, Philippines, Poland, Portugal, Russian Federation, Saudi Arabia, Senegal, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Tunisia, Turkey, United Kingdom, United States and Vietnam.

Plan to address BEPS, together with a plan for follow-up work and a timetable for implementation. Earlier reports have been consolidated with the remaining 2015 deliverables to produce a coherent set of recommendations for addressing BEPS. Many countries are poised to adopt changes to their international tax systems based on the OECD recommendations. The minimum standards are envisaged in the following Action Plans:

- Action Plan 5 – Harmful Tax Practices
- Action Plan 6 – Prevention of tax treaty abuse
- Action Plan 13 – Country-by-country reporting
- Action Plan 14 – Mutual Agreement Procedure

OECD established the Inclusive Framework (IF) on BEPS in 2016. It facilitated all interested countries and jurisdictions to collaborate on the implementation of the OECD/ G20 BEPS Package.

The IF on BEPS has brought together over 100 countries² and jurisdictions for implementing the BEPS package. Over 80 developing countries and other non-OECD/non-G20 economies discuss the challenges of BEPS through direct participation in the Committee on Fiscal Affairs, regional meetings in partnership with regional tax organisations, and thematic global fora. Many developing countries are now joining the inclusive framework.

9.2 Summary of Action Points

Action Plan 1 - Addressing the Tax Challenges of the Digital Economy

The digital economy is the result of a transformative process brought by information and communication technology (ICT). The ICT revolution has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. The digital economy being in a continuous state of evolution, the developments required a monitoring to evaluate their impact on tax systems.

² Some of the countries that have joined the IF in recent times are Anguilla, Bahamas, Bahrain, Barbados, Maldives, Mongolia, Oman, Qatar, Saint Kitts and Nevis, Saint Lucia, Serbia, Trinidad and Tobago, Tunisia, United Arab Emirates and Zambia.

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The digital economy and its business models presented some key features which are potentially relevant from a tax perspective. These features include *mobility*, with respect to (i) the intangibles on which the digital economy relies heavily, (ii) users, and (iii) business functions; *reliance on data*, the massive use of which has been facilitated by an increase in computing power and storage capacity and a decrease in data storage cost; *network effects*, which refer to the fact that decisions of users may have a direct impact on the benefit received by other users; *the spread of multi-sided business models*, in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affect the outcome for the other groups of persons through a positive or negative externality; *tendency toward monopoly or oligopoly* in certain business models relying heavily on network effects; and *volatility* due to lower barriers to entry into markets and rapidly evolving technology, as well as the speed with which customers can choose to adopt new products and services at the expense of older ones.

Broader tax challenges raised by the digital economy and the recommendations made in the report

The digital economy raises broader tax challenges for policy makers. These challenges relate in particular to nexus, data, and characterisation for direct tax purposes, which often overlap with each other. The digital economy also creates challenges for Value Added Tax (VAT) collection, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad.

Evolving ways of carrying on business raised questions about whether current nexus rules continued to be appropriate. The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business in a jurisdiction, combined with the increasing role of network effects generated by customer interactions, raised questions as to whether rules that rely on physical presence continue to be appropriate.

The Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs (CFA) in which non-OECD G20 countries participate as Associates on an equal footing with OECD countries, was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address them by September

2014. The TFDE consulted extensively with stakeholders and analysed written input submitted by business, civil society, academics, and developing countries. It issued an interim report in September 2014 and continued its work in 2015. The final report was published in October 2015.

Action Plan 1 is aimed at addressing BEPS issues in the digital economy (DE).

The emergence of new and intangible value drivers has created new business models while continuously eroding need for physical proximity to target markets. This continuously challenges existing profit allocation and nexus rules to distribute taxing rights on income generated from cross-border activities in a way that is acceptable to all countries. The DE presents some key features that may exacerbate BEPS concerns – mobility (intangibles, users and business functions), reliance on data, network effects, multi-sided business models, monopoly and volatility. The final report on DE asserts that DE business models facilitate the artificial shifting of income, avoidance of direct tax nexus and the avoidance of VAT. The final report concludes that work under the other BEPS Actions addresses many of the DE BEPS concerns, but also sets out additional measures countries may consider. These may be added by way of amendments to the domestic laws by countries or by re-negotiation of Tax treaties

The report states that the TFDE will continue its work by monitoring new DE business models and the effectiveness of BEPS measures with the objective of issuing a report on its work by 2020.

- The final report expects that adoption of the Permanent Establishment (PE) [OECD Model Treaty Article 5] modification of Action Plan 7 should effectively address many of the concerns with respect to direct tax nexus. Many DE business models operate through physical facilities located in market jurisdictions (e.g. e-commerce warehouses and computer server locations) to address latency concerns, or operate through local sales force of another local entity which plays a principal role in the conclusion of contracts (although the actual contract is signed by the online seller). Action Plan 7 modifications (to exceptions of 'preparatory and auxiliary' character and to the 'agency PE' rule) are expected to bring many of these businesses within the taxing rights of market jurisdictions.
- Revised Transfer Pricing (TP) guidance (Action Plans 8-10) makes it

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clear that legal ownership alone does not justify the right to intangibles profits – limiting the current mobility of DE profits. The TP guidelines will allocate profits to group members performing important functions, contributing important assets and controlling significant risks. Coupled with a broader definition of taxable nexus, these guidelines are expected to subject a greater share of DE profits to market country taxation.

- Subjecting DE profits to Controlled Foreign Company (CFC) taxation pursuant to the recommendation of Action 3 (Strengthening CFC Rules) is also expected to be an important factor in eliminating stateless DE income and the incentives for tax-motivated operating structures. The final report suggests that CFC rules targeting typical DE income (e.g. royalties, sale of digital products and digital services) or excess profits from Intellectual Property (IP) related assets would be effective measures to curtail DE BEPS concerns.
- The report recommends application of principles as per the International VAT/GST Guidelines and introduction of the appropriate collection mechanism. Apparently, the effective model for collection of VAT could be the vendor collection model where the offshore vendor registers and pays the tax in the consumer jurisdiction.
- The report concludes that data is often a 'primary input' for value creation in the DE. Nevertheless, significant uncertainty remains as to how to deal with data in the DE: should collecting data cause taxable nexus? If so, how to attribute profits from the use of data to that nexus? and how should data-related income be characterised?
- The final report further develops alternative options addressed in its 2014 work: (1) significant economic presence nexus (nexus would be established where a non-resident has a significant economic presence evidenced by factors such as revenue from remote transactions, local domain names, localized websites, local currency payment options, number of active users in a country, online contracting and data collection); (2) withholding taxes on digital income from goods or services ordered online (tax could be a final tax or as a back-up measure to enforce net-basis taxation); and (3) 'equalization levy' (tax to equalize the tax burden on remote and domestic suppliers of similar goods and services, similar to an insurance excise taxes imposed

upon foreign insurers). These measures could be imposed through domestic legislation and are not recommended as an international standard. However, the report states that countries may wish to impose these measures to address DE BEPS concerns that those countries believe are not adequately addressed by the OECD's recommendations, or as a 'stop-gap' measure until the OECD's recommendations are fully implemented.

- The final report states that the character of many forms of DE income, including cloud computing, is not addressed in the existing commentary to the OECD Model Treaty (royalties, technical services or business profits). The Working Party is mandated to clarify the characterization of such income under the current tax treaty rules and its work is to be completed with full participation of associate member countries in the BEPS process.

The IF of the OECD/G20 on BEPS delivered the interim report <https://www.oecd.org/tax/covid-19-tax-policy-and-other-measures.xlsm> Tax Challenges Arising from Digitalisation – Interim Report 2018. The interim report highlighted the complexity of the issue and the report stated that preliminary evidence suggested that the implementation of the BEPS actions is already having an impact. The Interim Report also embodied a commitment from all members of the OECD/G20 IF to undertake a coherent and concurrent review of the nexus and profit allocation rules that would consider the impacts of digitalisation on the economy, relating to the principle of aligning profits with underlying economic activities and value creation.

In January 2019, the OECD released a 'Policy Note' which, amongst other things, dealt with a number of proposals to address the tax challenges of the digitalisation of the economy. Aligning with the analytical framework of both the Action Plan 1 report and the Interim report, TFDE agreed to examine four proposals involving two pillars which could form the basis for consensus. One pillar addresses the broader challenges of the digitalised economy and focuses on the allocation of taxing rights, and a second pillar addresses remaining BEPS issues.

Policy note and public consultation documents published so far, contain concrete proposals made by members framed within two complementary pillars, as under:

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Pillar 1 - Re-allocation of taxing rights

- Addresses the question of business presence and activities without physical presence;
- Will determine where tax should be paid and on what basis;
- Will determine what portion of profits could or should be taxed in the jurisdictions where customers and/or users are located;

Pillar 2 - Global anti-base erosion mechanism:

- Will help to stop the shifting of profits to low or no tax jurisdiction facilitated by new technologies;
- Will ensure a minimum level of tax is paid by multinational enterprises (MNEs);
- Levels the playing field between traditional and digital companies;

Steps taken around the world so far to address the tax challenge of the digital economy

Worldwide, countries/regions have started to introduce levies which are based on the other options analysed by the TFDE.

The European Union (EU) has proposed new rules for the taxation of digital business activities in the EU region. It dealt with two legislative proposals that were put forward to provide for taxation of digital activities in the EU region. The said proposals included Directives on a Digital Services Tax (DST – as an interim measure) and the introduction of a digital permanent establishment concept (SDP). This was followed by a number of countries³ that have proposed measures for the taxation of the digital activities/services. Countries like Israel have introduced provisions on the concept of Significant Economic Presence (SEP) to clarify the circumstances in which a foreign enterprise engaged in online activities ('activities via the internet') may be liable to corporate income tax in Israel. Expanded definition of a 'fixed place of business' for certain digital platforms has been introduced by Slovakia providing that the repeated activities of a non-resident enterprise in the form of facilitation of conclusion of contracts through an online platform in relation to provision of services of transportation and accommodation are deemed to be activities carried out through a fixed place of business in Slovakia.

³ France, U.K. Austria, Australia, Spain, Uruguay, Italy, etc.

There have been some countries that have introduced levies on the lines of Action Plan suggestions in the domain of 'indirect tax as well.

India perspective

Recognizing the significance of issues relating to e-commerce transactions, the Government of India had constituted a Committee which was given a mandate to deal with details of the business models for e-commerce, the direct tax issues in regard to e-commerce transactions and a suggested approach to deal with these issues under different business models. In February 2016, the Committee submitted its report to the Government recommending the adoption of the 'equalization levy' to address the tax challenges of digital economy and provide greater certainty and predictability in its taxation.

In line with this, the Finance Act, 2016 introduced an 'equalisation levy' in India at the rate of 6 percent of the amount of consideration for online advertisement, digital advertising space or any other facility or service for the purpose of online advertisement and includes any other service as may be notified; received or receivable by a non-resident not having PE in India, from a resident in India who carries out business or profession, or from a non-resident having PE in India.

However, the manner in which this levy has been introduced, does not seem that it forms a part of the Income-tax Act as it has been introduced as a separate chapter in the Finance Bill. This may raise questions as to whether the amount paid on account of the equalization levy would be subject to credit of tax in the home country. The BEPS report clearly states that countries could introduce the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties.

Expansion of Scope of Equalisation Levy

Government of India, vide Finance Act, 2020 has expanded the scope of equalisation levy and has introduced a new section 165A in the Finance Act 2016.

As per the said section, an e commerce operator shall be liable to charge equalisation levy at the rate of two per cent of the amount of consideration received or receivable from e-commerce supply or services made or provided or facilitated by it to the following persons:

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- to a person resident in India; or
- to a non-resident in specified circumstances. i.e. sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement through internet protocol address located in India; and sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India
- to a person who buys such goods or services or both using internet protocol address located in India.

Specified Transactions

E-commerce supply or services means

- online sale of goods owned by the e-commerce operator;
- online provision of services provided by the e-commerce operator; or
- online sale of goods or provision of services or both, facilitated by the e-commerce operator; or
- any combination of activities listed in clause (i), (ii) or clause (iii)

E-commerce operator

E-commerce operator means a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both.

Exclusions

The equalisation levy shall not be charged where

- the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment
- the equalisation levy is leviable under section 165 of Finance Act 2016
- sales, turnover or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated is less than two crore rupees during the previous year

Payment of Equalisation Levy

The equalisation levy referred to section 165A above, shall be paid by every e-commerce operator to the credit of the Central Government as under:

Date of ending of the quarter of financial year	Due date of payment
30 th June	7 th July
30 th September	7 th October
31 st December	7 th January
31 st March	31 st March

Significant Economic Presence

With a view to cover emerging business models such as digitised businesses, which do not require physical presence of itself or any agent in India, Finance Act, 2018 introduced amendments to domestic nexus rules (Section 9(1)(i) of the Act) for income tax purposes within the concept of 'business connection' under the Act.

Significant Economic Presence (SEP) of a non-resident enterprise shall constitute 'business connection' in India and such income shall be deemed to accrue or arise in India. SEP covers the following two distinct situations:

- Transaction in respect of any goods, services, or property carried out by a non-resident in India, including the provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed.
- Systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

The transaction or activities shall constitute SEP in India, whether or not the non-resident has a residence or a place of business in India or renders services in India or the agreement for such transactions or activities is entered in India.

There are several issues which have arisen on account of the introduction of the SEP provisions in India, for e.g. the SEP provisions are so broadly worded that it may cover not only digital transactions but also transactions relating to physical goods, within its ambit. Some of the terms have not been clearly defined in the SEP provisions. There may arise a conflict about the

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applicability of the TDS provisions as against the SEP provisions to certain digital transactions.

Action Plan 1 states that adoption of these measures require further calibration/ adaptation to ensure consistency with the existing international legal commitments. Introduction of SEP provisions in India without an international consensus may pose challenges like double taxation, compliance and administrative cost, uncertainty, litigation, etc.

There are certain minor drafting changes suggested by the Finance Act 2020 to the definition of SEP. Further, in order to determine the thresholds for the applicability of SEP provisions, they have been deferred to AY 2022-23.

Action Plan 2 - Neutralising the Effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

The role played by hybrid mismatch arrangements in aggressive tax planning has been discussed in a number of OECD reports. For example, an OECD report on *Addressing Tax Risks Involving Bank Losses* (OECD, 2010) highlighted their use in the context of international banking. Similarly, the OECD report on *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD, 2011) recommended countries “consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results.”

The aim of Action Plan 2 is to develop model treaty provisions and recommendations for the design of domestic rules to neutralise mismatches arising from the use of hybrid instruments and entities. The OECD issued a discussion draft on 19 March 2014 and an interim report with recommendations was published on 16 September 2014, although it identified certain important issues where further work was required. In line with earlier recommendations, the final report recommends the introduction of hybrid mismatch rules and certain other domestic provisions to counter hybrid arrangements, together with a proposed change to the model treaty to ensure hybrid entities are not used to obtain treaty benefits unduly. The

report contains detailed guidance and numerous examples to explain how the domestic provisions are intended to operate in practice. The report set out recommendations in two Parts. Part I contains recommendations for changes to domestic law and Part II sets out recommended changes to the OECD Model Tax Convention.

Part 1 – Design of the domestic law rules

Part I of the report set out the recommendations for the design of the domestic law rules. It has recommended specific improvements to domestic law, designed to achieve a better alignment between those laws and their intended tax policy outcomes (specific recommendations) and the introduction of linking rules that neutralise the mismatch in tax outcomes under a hybrid mismatch arrangement without disturbing any of the other tax, commercial or regulatory consequences (hybrid mismatch rules).

In terms of specific changes to domestic law, the report recommended improvements to domestic law rules that:

- Deny a dividend exemption, or equivalent relief from economic double taxation, in respect of deductible payments made under financial instruments.
- Introduce measures to prevent hybrid transfers being used to duplicate credits for taxes withheld at source.
- Alter the effect of CFC and other offshore investment regimes to bring the income of hybrid entities within the charge to taxation under the laws of the investor jurisdiction.
- Encourage countries to adopt appropriate information reporting and filing requirements in respect of tax transparent entities established within their jurisdiction.
- Restrict the tax transparency of reverse hybrids that are members of a control group.

In addition to these specific recommendations, Part I also set out recommendations for hybrid mismatch rules that adjust the tax outcomes under a hybrid mismatch arrangement in one jurisdiction in order to align them with the tax outcomes in the other jurisdiction. These recommendations target payments under a hybrid mismatch arrangement that give rise to one of the three following outcomes:

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- *Payments that give rise to a deduction / no inclusion outcome (D/NI outcome)*, i.e. payments that are deductible under the rules of the payer jurisdiction and are not included in the ordinary income of the payee.
- *Payments that give rise to a double deduction outcome (DD outcome)*, i.e. payments that give rise to two deductions in respect of the same payment.
- *Payments that give rise to an indirect D/NI outcome*, i.e. payments that are deductible under the rules of the payer jurisdiction and that are set-off by the payee against a deduction under a hybrid mismatch arrangement.

D/NI outcomes

Both payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/NI outcomes. In respect of such hybrid mismatch arrangements it is recommended that the response should be to deny the deduction in the payer jurisdiction. In the event the payer jurisdiction does not neutralise the mismatch, a defensive rule is recommended that would require the payment to be included as ordinary income in the payee jurisdiction.

DD outcomes

As well as producing D/NI outcomes, payments made by hybrid entities can, in certain circumstances, also give rise to DD outcomes. In respect of such payments the report recommends that the primary response should be to deny the duplicate deduction in the parent jurisdiction. A defensive rule, that would require the deduction to be denied in the payer jurisdiction, would only apply in the event the parent jurisdiction did not adopt the primary response.

Indirect D/NI outcomes

Once taxpayers have entered into a hybrid mismatch arrangement between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter for the effect of that mismatch to be shifted into a third jurisdiction (through the use of an ordinary loan, for example). Therefore, in order to protect the integrity of the recommendations, it is further recommended that a payer jurisdiction deny a deduction for a payment where the payee sets the income from that payment off against expenditure under a separate hybrid mismatch arrangement.

Base Erosion Profit Shifting

The hybrid mismatch rules are not generally intended to pick-up mismatches that are attributable to differences in the value ascribed to a payment. For example, gains and losses from foreign currency fluctuations on a loan can generally be ignored for the purposes of the hybrid mismatch rules.

The table given below provides an overview of the hybrid mismatch rules recommended in this report.

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive Rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax Credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction	-	Control group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to control group and structured arrangements

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Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive Rule	Scope
	Deductible payment made by dual resident		Deny resident deduction	-	No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction	-	Members of control group and structured arrangements

Part 2 - Recommendation to the OECD Model Tax Convention

Part II of this report complements Part I and deals with the parts of Action Plan 2 recommending to include changes to the OECD Model Tax Convention (OECD, 2014) to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly and that special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention.

The proposed change to the model treaty involves only allowing income that is derived by or through an entity which is treated as fiscally transparent in the contracting state, to be considered as income of a resident of a contracting state for the purposes of the treaty to the extent that it is treated as income of the resident for tax purposes in that state.

The report also says that countries that intend to implement the domestic provisions should consider amending their tax treaties which include an exemption method for dividends in order to eliminate double taxation to, instead, apply a credit method, either as a general rule or with respect to tax deductible dividends.

The provision relating to the proposed change to the OECD model treaty which is to ensure that hybrid entities are not used to obtain treaty benefits unduly is already included in a number of US tax treaties, including that with the UK.

The BEPS Action Plan 2 recommendations targeted mismatches resulting

from differences in the tax treatment of instruments or entities. They do not however, directly deal with mismatches that arise through the use of branch structures. These 'branch mismatches' occur where the head office and branch jurisdiction take a different view as to the allocation of income and expenditure between the branch and head office and they include situations where the branch jurisdiction does not treat the taxpayer as having a taxable presence in that jurisdiction.

The OECD/G20 IF considered that branch mismatch arrangements offer multinationals opportunities to reduce their overall tax burden by exploiting differences in the rules governing the allocation of payments between two jurisdictions.

Given the similarity between hybrid and branch mismatches, both in terms of structure and outcomes, OECD issued a further report on 'Neutralising the Effect of Branch Mismatch Arrangements' in July 2017, setting out recommendations for branch mismatch rules that would bring the tax treatment of these arrangements into line with the approach set out in the BEPS Action Plan 2 recommendations.

Global developments to address the issue arising out of hybrid mismatch arrangements

Since the OECD has no power in itself to implement law, the exact implementation of these proposals will depend on individual states implementing domestic law and amending treaties (although the latter may be achieved through Action Plan 15 i.e. the proposed multilateral instrument). The timeframe for changes is likely to vary from country to country.

In light of the OECD proposals on hybrid mismatch arrangements under Action 2 of the BEPS Action Plan, the UK has changed its domestic rules that apply to payments made on or after 1 January 2017. The UK rules closely follow the OECD's recommendations and replace the UK's previous anti-arbitrage rules.

EU Member States adopted hybrid and branch mismatch rules in Council Directive (EU) 2017 (ATAD 2) and hybrid mismatch rules were also included as part of the US tax reform legislation, which passed into law at the end of last year. In addition, both the Australian and New Zealand governments have introduced legislative proposals for neutralising the hybrid and branch mismatches that are in line with the Action 2 recommendations.

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Apart from the UK, there is widespread acceptance in Europe that tax planning based on hybrid mismatches will be curtailed. Switzerland, Germany and other countries have already moved to prevent companies from using hybrid structures for the sole purpose of gaining tax advantages. Irish domestic law already limits opportunities for specific hybrid structures. Legislative provisions broadly require that the income from such arrangements is taxable to the lender in order to ensure that certain interest payments remain tax-deductible as interest, rather than being characterized as non-deductible dividends or distributions for Irish tax purposes.

Austria has, in its tax reform proposal in the draft bill 2019-2020, recently introduced the provisions against hybrids provided by the EU-directive 2017/952 (ATAD 2) into domestic law as from 1 January 2020.

The Czech Republic has also enacted the hybrid mismatch rules that aim to neutralise the effects of hybrid mismatch arrangements such as a “double deduction” when one amount reduces the tax base in more than one jurisdiction, or a “deduction without inclusion” when the tax base is reduced in one jurisdiction without the same amount being included in the tax base in another jurisdiction.

The provisions of MLI, dealing with tax treatment of transparent entities provides that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either contracting jurisdiction shall be considered to be income of a resident of a contracting jurisdiction but only to the extent that the income is treated, for purposes of taxation by that contracting jurisdiction, as the income of a resident.

Since this is not a minimum standard under MLI, India has decided that it will not apply this Article to any of its CTAs. Hence, this provision does not affect any of India’s tax treaties.

Action Plan 3 - Designing Effective Controlled Foreign Company Rules

Action Plan 3 recognises that groups can create non-resident affiliates to which they shift income and that these affiliates may be established wholly or partly for tax reasons rather than for non-tax business reasons. Controlled foreign company (CFC) and other anti-deferral rules combat this by enabling jurisdictions to tax income earned by foreign subsidiaries where certain conditions are met.

CFC rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

The objective of Action Plan 3 is to address BEPS by designing effective CFC rules. By taxing the income of non-resident subsidiaries in the hands of the resident shareholders, robust CFC rules can prevent groups from establishing low-taxed non-resident affiliates to which they shift income which is often subject to indefinite deferral. The OECD issued a discussion draft on 3 April 2015, which provided recommendations on the key 'building blocks' necessary to develop effective CFC rules for dealing with BEPS. The building blocks are intended to allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations.

Consistent with the discussion draft, the OECD final report sets out recommendations for six building blocks: (1) rules for defining a CFC (including definition of control); (2) CFC exemptions and threshold requirements; (3) definition of CFC income; (4) rules for computing income; (5) rules for attributing income; and (6) rules to prevent or eliminate double taxation. The final report generally confirms the recommendations of the discussion draft but modifies certain aspects on some building blocks and provides more detailed guidance on others. Most significantly, regarding (3) the final report significantly revamped this income issue, makes an affirmative recommendation regarding income attribution and provides modified income attribution options.

The recommendations of the Action Plan

- The CFC rules should broadly define entities that are within the scope of the CFC definition so that, in addition to including corporate entities, CFC rules could also apply to certain transparent entities (partnerships, trusts) and PEs if those entities earn income that raises BEPS concerns and those concerns are not addressed in another way.
- The CFC rules should apply both a legal and an economic control test (generally set at more than 50 per cent, although countries could, if they so choose, achieve broader policy goals by setting a lower threshold) so that satisfaction of either test results in control.

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- CFC rules should include a tax rate exemption that would allow companies that are subject to an effective tax rate that is sufficiently similar to the tax rate applied in the parent jurisdiction not to be subject to CFC taxation. The recommended benchmark would be no greater than 75 per cent of the statutory corporate rate in the parent or shareholder jurisdiction. Whitelists could be used to simply/supplement the effective tax rate test.
- Possible approaches to defining CFC income that should be attributed to controlling shareholders are identified, including: (1) a categorical analysis (of incomes such as dividend, interest, insurance income, royalties and IP income, sales and services income); (2) a substance analysis (to determine whether CFC is engaged in substantial activities); and (3) an excess profits analysis (taxing at the shareholder level returns in excess of 'normal return' earned in low tax jurisdictions).
- However, defined CFC income should be computed using the rules of the parent jurisdiction for determining income. To the extent, legally permitted jurisdictions should have a specific rule limiting the offset of CFC losses so that they can only be used against the profits of the same CFC or against the profits of other CFCs in the same jurisdiction.
- Income should be attributed only to shareholders having a minimum threshold of control, and the amount of income to be attributed to each shareholder or controlling person should be calculated by reference to both their proportion of ownership and their actual period of ownership or influence. Tax should be applied at the tax rate of the parent jurisdiction; however, a second option would be to apply a 'top-up tax' (the difference between the tax paid by the CFC and, for example, the rate threshold used to determine whether the CFC rules apply). In either case, credit should be allowed for foreign taxes actually paid (including CFC tax assessed by other countries on intermediate companies).
- The final report also recommends that exemption should be granted in CFC rules for dividend income and gains on disposition of CFC shares if the income of CFC has previously been subject to CFC taxation.

Developments in various countries across the world with regards to implementation of the CFC provisions

The USA made significant changes to the CFC rules effective for taxable year beginning after 31 December 2017. The key provisions include: (i) expanding the conditions under which a foreign corporations may be treated as a CFC; (ii) creating a new category of CFC income, referred to as "global intangible low-taxed income; (iii) imposing a repatriation tax on offshore earnings of CFC that have been deferred offshore and not previously subject to US corporate income tax; and (iv) providing a new participation exemption for foreign-source dividends paid to US corporate shareholders of a "specified 10-percent owned foreign corporation", including a CFC.

With the new EU Anti-tax Avoidance Directive 1 (ATAD) to be implemented with effect from 1 January 2019, a brief snap shot is provided below of the certain European countries' response to strengthen the CFC rules in light of the ATAD 1 along with the recommendations of the OECD BEPS Action Plan 3.

Sr. No.	Country	Response
1.	Czech Republic	There are new rules that apply with regard to the taxation of income of a foreign company controlled by the Czech controlling company when: (1) the foreign company does not conduct any substantial economic activity; and (2) its tax liability abroad is less than one half of the tax liability that it would have had if it were taxed under Czech tax laws.
2.	Cyprus	CFC rules introduced in the Cypriot law with effect from 1 January 2019.
3.	Finland	CFC legislation implemented
4.	France	CFC legislation in force
5.	Germany	CFC legislation in force
6.	Greece	CFC rules apply from 2014 onwards
7.	Iceland	CFC legislation introduced in 2013
8.	Italy	CFC rules are enacted that are aligned to the EU ATAD
9.	Poland	CFC rules introduced from 2015
10.	Portugal	CFC rules tightened under 2014 reform

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Sr. No.	Country	Response
11.	Russia	CFC rules enacted from 2015
12.	Spain	CFC rules recently strengthened
13.	Sweden	CFC legislation in force
14.	Turkey	CFC rules in effect
15.	United Kingdom	CFC rules in force;

India perspective

In the past, the Indian government had made an attempt to introduce the CFC regime in India under the framework of Direct Taxes Code Bill, 2010 (DTC), which lapsed. However, India has introduced the Place of Effective Management (POEM) rules from the FY 2016-17. POEM is an internationally recognized test for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognise the concept of POEM for determination of the residence of a company as a tie-breaker rule for the avoidance of double taxation.

In January 2017, the CBDT issued guiding principles vide Circular No. 06/2017 dated 24 January 2017. The said guiding principles may be considered as an effective tool to determine the POEM of a particular company. The guiding principles are primarily based on the fact as to whether or not the company is engaged in 'active business outside India'. For determination of 'active business outside India' factors such as passive income, total asset base, the number of employees, payroll expenses in India and outside, etc. are considered. The guiding principles state that the concept of POEM is one of substance over form. However, the real determination of POEM of a company is essentially an exercise which may be driven by complex set of facts. It is only after appreciating the factual position that the POEM of a company may be determined for the purpose of tax residency in India. The CBDT released clarification on 23 February 2017 stating that the provision of clause (ii) of sub-section 3 of section 6 of the Act, shall not apply to a company having turnover or gross receipts of ` 50 crores or less in a financial year.

Further, the government has also notified the provisions providing for the tax consequences (for e.g. determination of Written down value and brought

forward losses, foreign tax credit, etc.) on a foreign company said to be resident in India due to its POEM being in India.

Action Plan-4 - Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

The inherent characteristic of money being that it is mobile and fungible, multinational groups may achieve favourable tax results by adjusting the amount of debt in a group entity. The influence of tax rules on the location of debt within multinational groups has been established in a number of academic studies and it is well known that groups can easily multiply the level of debt at the level of individual group entities via intra-group financing. Financial instruments can also be used to make payments which are economically equivalent to interest but have a different legal form, therefore escaping restrictions on the deductibility of interest.

Action Plan 4 seeks to develop recommendations in the design of rules limiting the deductibility of interest and other economically equivalent payments made to third parties and related parties. The BEPS risks identified in this area are (a) use of related-party and third-party debt to achieve excessive interest deductions (b) to finance the production of exempt or deferred income (c) obtain relief for interest deductions greater than the actual net interest expense of the group.

The OECD released a discussion draft on 18 December 2014 which focused on three potential approaches: a group-wide rule, a fixed ratio rule, or a combination of those two rules. In its final report, the OECD recommends a combination approach where a fixed ratio rule is the default rule and a group ratio rule applying at a country's election. Furthermore, the OECD supplements the best practice approach with additional optional elements and targeted rules.

- Under the fixed ratio rule, an entity's deductible interest expense would be limited to a fixed ratio of the entity's earnings before interest, taxes, depreciation and amortisation (EBITDA). In lieu of EBITDA, countries could choose to apply EBIT, which represents more of a cash flow measure. These computations would be done based on tax numbers. The report recommends that the fixed ratio be between 10 per cent and 30 per cent. If applied as a stand-alone rule, the fixed ratio approach is recommended to apply to both multinationals and purely domestic entities.

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- Under the group ratio rule, interest expenses are deductible up to the level of the net third party interest/EBITDA ratio of the group. This earnings-based group ratio rule can also be replaced by different group ratio rules, which are based on an equity or asset comparison. To prevent double taxation, countries may also apply an uplift to a group's net third party interest expense up to 10 per cent.
- The recommendations apply to payments of interest equivalents and expenses incurred in raising finance, including imputed interest on convertible bonds or zero-coupon bonds, the finance cost element of finance lease payments and guarantee fees.
- The additional optional elements consist of (i) a de minimis threshold which carves-out entities with a low level of net interest, (ii) a carry forward of disallowed interest/unused interest capacity and/or carry back of disallowed interest, and (iii) an exclusion for third-party interest funding certain public-benefit assets.

The OECD recommends the targeted rules to prevent a circumvention of the general rules (fixed ratio rule and group ratio rule) as well as to address other BEPS risks.

It has also been recognized that the banking and insurance sectors have specific features which must be taken into account and therefore there is a need to develop suitable and specific rules that address BEPS risks in these sectors.

As noted above, the final report included a detailed outline of a rule based on the net third party interest/EBITDA ratio of a consolidated financial reporting group, and provided that further work would be conducted in 2016 on elements of the design and operation of the rule. The updated report was published in December 2016. The updated report did not change any of the conclusions agreed in 2015, but provided a further layer of technical detail to assist countries in implementing the group ratio rule in line with the common approach. This approach emphasised the importance of a consistent approach in providing protection for countries and reducing compliance costs for groups, while including some flexibility for a country to take into account particular features of its tax law and policy.

In the context of risks posed by entities in the banking and insurance sectors, the updated report examined regulatory and commercial requirements which constrain the ability of groups to use interest for BEPS purposes, and limits

on these constraints. Overall, a number of features reduce the risk of BEPS involving interest posed by banking and insurance groups, but differences exist between countries and sectors and in some countries risks remain. Each country should identify the risks it faces, distinguishing between those posed by banking groups and those posed by insurance groups. Where no material risks are identified, a country may reasonably exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional tax rules. Where BEPS risks are identified, a country should introduce rules appropriate to address these risks, taking into account the regulatory regime and tax system in that country. The updated report considers how these rules may be designed, and includes a summary of selected rules currently applied by countries. In all cases, countries should ensure that the interaction of tax and regulatory rules and the possible impact on groups is fully understood.

The amount of intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules. Revisions to Chapter on the Transfer Pricing Guidelines for Multinational Enterprises (MNE's) and Tax Administrations under Actions Plan 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) of the BEPS Action Plan limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided and require group synergies to be taken into account when evaluating intragroup financial payments. Further work on the transfer pricing aspects of financial transactions has been undertaken during 2017.

Given below is the response of jurisdictions in line with Action Plan 4:

A number of OECD/G20 IF members⁴ have adopted interest limitations rules or are in the process of aligning their domestic legislation with the recommendations of BEPS Action Plan 4.

Pursuant to the US tax reform legislation, US taxpayers are not permitted to deduct net interest expense on loans from third parties and related parties in excess of 30 per cent of their adjusted taxable income, an amount which approximates EBITDA.

As part of Council Directive (EU) 2016/1164 (ATAD 1) EU Member States

⁴ Argentina, India, Japan, Malaysia, South Korea, South Africa, Turkey and Viet Nam.

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have agreed to adopt an interest cap that will restrict a taxpayer's deductible borrowing costs (including on third party debt) to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

India perspective

In line with the BEPS Action Plan 4 recommendations, India introduced the provisions relating to limitation of interest deduction in certain cases. Finance Act 2017 introduced section 94B which provided that where an Indian company or PE of a foreign company, being borrower, incurs any expenditure by way of interest or similar nature consideration exceeding INR one crore, it shall be limited to 30 per cent of earnings before interest, taxes, depreciation, and amortization (EBITDA), or interest paid or payable to associated enterprises, whichever is less.

Banking and Insurance business has been excluded from the ambit of the aforesaid provisions keeping in view the special nature of these businesses.

Action Plan – 5 - Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

The OECD started work on addressing harmful tax competition in the late 1990s and the publication of the OECD's 1998 Report *Harmful Tax Competition: An Emerging Global Issue* which has been issued way back in the late nineties had the same policy concerns which are as much relevant in today's times as they were then. The concerns deal with preferential regimes that risk being used for artificial profit shifting and about a lack of transparency in connection with certain rulings. The goal of OECD's work in the area of harmful tax practices is to secure the integrity of tax systems by addressing the issues raised by the regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services.

Taking forward the work laid down in the 1998 report, OECD released an interim report in September 2014 titled 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance', which reflects the importance of having appropriate 'substantial activity' requirements in preferential regimes and on the need for increased transparency.

The continued importance of the work on harmful tax practices was highlighted by the inclusion of this work in the Action Plan on (BEPS Action

Plan, OECD, 2013), whose Action Plan 5 committed the Forum on Harmful Tax Practices (FHTP) to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes and on requiring substantial activity for any preferential regime.

The goal of Action Plan 5 is to identify preferential regimes, introduce compulsory spontaneous information exchange on rulings related to preferential regimes and require substantial activity for any preferential regime including IP regimes. The OECD published a report on 16 September 2014 stating that progress has been made to date by the Forum on Harmful Tax Practices (FHTP) in (i) determining the parameters within which preferential tax regimes should operate going forward, in relation to substantial activity, and (ii) in improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

- The FHTP considered three different approaches (value creation approach; transfer pricing approach and the nexus approach) for requiring substantial activities in an IP regime. For IP regimes, the report agrees on the so-called 'nexus' approach which seeks to directly link IP regime benefits to the claimant company's contribution to the development of the IP in question, measured by reference to the related R&D expenditure as a proportion of total R&D expenditure, with expenditure acting as a proxy for activity. The proposal is based on a formula: eligible IP income for the IP regime = (qualifying expenditure incurred to develop the IP asset divided by overall expenditure incurred to develop the IP asset) x overall income from that IP asset.
- Qualifying expenditures must be directly connected to the IP asset and will in principle not include interest payments, building costs, acquisition costs and related party outsourcing. A 30% 'up-lift' for qualifying expenditures is allowed to the extent that the taxpayer has non-qualifying expenditures.
- As a transitional arrangement, the report concludes that no new entrants will be permitted in any existing IP regime not consistent with the nexus approach after 30 June 2016. Countries can allow taxpayers benefiting from an existing IP regime to keep such entitlement until 30 June 2021 at the latest.

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- The report notes that a framework covering all rulings has been agreed. The framework builds on earlier OECD guidance, taking into account the Convention of Mutual Assistance in Tax Matters and the European Union's Council Directive on Administrative Cooperation in the field of taxation (2011/16/EU). The framework covers all taxpayer specific rulings, advance tax rulings, Advance Pricing Agreements (APAs) and general rulings. For countries which have the necessary legal basis, exchange of information will take place from 1 April 2016 for future rulings. For past rulings, the report confirms that rulings that have been issued on or after 1 January 2010 and were still in effect as from 1 January 2014 must be exchanged. The exchange of past rulings will need to be completed by 31 December 2016.

Review of OECD and associate country regime

In 2010, the FHTP started a review process of preferential tax regimes in member countries and associated countries, which covers 43 regimes, which comprised of 16 IP regimes and 27 non-IP regimes. The FHTP concluded all 16 IP regimes as inconsistent with the nexus approach. Of the remaining 27 non IP regimes, 19 were considered as not harmful. Out of balance eight, four regimes were under review, and the remaining four were in the process of being eliminated.

Further work of the FHTP

In respect of information exchange, a monitoring and review mechanism needs to be put in place to help ensure countries' compliance with the obligation to exchange information at the start of 2017. The need to involve third countries was recognised and the FHTP was requested to develop a strategy to engage non-OECD/non-G20 countries into the work on harmful tax practices.

BEPS Action Plan 5 is one of the four BEPS minimum standards which all Inclusive Framework members have committed to implement. Pursuant to the release of the final report of BEPS Action Plan 5, OECD conducted peer review to identify features of such regimes that can facilitate BEPS, and therefore have the potential to unfairly impact the tax base of other jurisdictions.

Thereafter, OECD has released progress reports on the preferential rulings which contains results demonstrating that jurisdictions have delivered on their commitment to comply with the standard on harmful tax practices,

including ensuring that preferential regimes align taxation with substance. The assessments are conducted by the FHTP, comprising of the more than 120 member jurisdictions of the Inclusive Framework. The progress report released by OECD in January 2019 comprises of new conclusions of 57 regimes.

Another part of the BEPS Action Plan 5 minimum standard is the compulsory spontaneous exchange of information on tax rulings (the 'transparency framework') that provides tax administrations with timely information on rulings that have been granted to a foreign related party of their resident taxpayer or a permanent establishment, which can be used in conducting risk assessments and which, in the absence of exchange, could give rise to BEPS concerns.

OECD has conducted the peer review of jurisdictions for the Calendar 2017 on the Exchange of Information on tax rulings and released the report December 2018.

The peer review report assessed 92 individual jurisdictions' progress in spontaneously exchanging information on tax rulings transpiring into the second peer review report.

India perspective

The following has been discussed in the Indian context, while dealing with the harmful regimes in the latest peer review report released by OECD:

- (i) Non-IP regime: None of the non-IP regimes discussed in the report, viz. Deductions in respect of certain incomes of offshore banking units and international financial services centre; Special provisions in respect of newly established units in special economic zones; Special provisions relating to income of shipping companies – tonnage tax scheme; Taxation of profit and gains of life insurance business have been considered harmful nor do they exhibit any harmful features by OECD in the report.
- (ii) IP regimes: To encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India and in response to the BEPS Action Plan 5, India has introduced a concessional taxation regime for income from patents, to provide that where the total income of the eligible assessee includes any income by way of royalty in respect of a patent developed and

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registered in India, then such royalty shall be taxable at the rate of ten per cent (plus applicable surcharge and cess) on the gross amount of royalty.

The peer review report has observed that the aforesaid IP regime which has been introduced by India is also not harmful and the substance requirements (nexus approach) are in place.

In the context of the other peer review report on exchange of information on tax rulings released by OECD, the following observations have been made in the Indian context:

- (i) Information gathering process: India has met all of the terms of reference for the information gathering process except for sufficiently applying the “best efforts approach” for past rulings and for identifying all potential exchange jurisdictions for future rulings. India is recommended to continue to apply the “best efforts approach” to identify potential exchange jurisdictions for all past rulings and to ensure that all potential exchange jurisdictions are identified swiftly for all future rulings.
- (ii) Exchange of information: India has the necessary legal basis for spontaneous exchange of information. India experienced delays in the exchange of past rulings and in the exchange of all future APAs partly due to the time intensive identification of the potential exchange jurisdictions and partly because of the volume of past and future rulings that had to be verified for accuracy and exchanged. India amended its processes of providing information to the Competent Authority in early 2018. India is recommended to ensure that all information on past and future APAs is exchanged as soon as possible

Action Plan – 6 - Preventing the granting of treaty benefits in inappropriate circumstances

Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries have therefore agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping. They also agree that some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country’s specificities and to the circumstances of the negotiation of bilateral conventions.

The OECD released three discussion drafts on 14 March 2014, 21 November 2014 and 22 May 2015, as well as an interim version of deliverable on 16 September 2014. The final report on Action Plan 6 supersedes the interim version issued in September 2014.

The objectives of Action Plan 6 are to: (i) develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances (i.e. treaty abuse and treaty shopping cases); (ii) clarify that tax treaties are not intended to be used to generate “double non-taxation”; and (iii) identify tax policy considerations for jurisdictions to consider before entering into treaties. The OECD released three discussion drafts on 14 March 2014, 21 November 2014 and 22 May 2015, as well as an agreed deliverable on 16 September 2014.

- Consistent with the earlier draft the final report recommends following a three pronged approach to address treaty shopping arrangements:
 - Clarification in treaty title and preamble to the effect that the Contracting States intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance;
 - Inclusion of a specific anti-abuse rule based on Limitation of Benefit (LOB) provisions (in line with such clauses in US tax treaties);
 - Addition to tax treaties of a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or ‘PPT’ rule).
- The report further recommends ‘minimum standard’ to counter treaty shopping whereby countries will include one of the following types of rules:
 - Combined approach of both a PPT and LOB rule in tax treaties;
 - PPT rule alone in tax treaties; or
 - An LOB in tax treaties supplemented by domestic anti-conduit financing legislation
- The final report includes draft provisions for both a U.S.-style LOB and for a ‘simplified’ LOB, both of which are based on the 2014 deliverable

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and subsequent discussion drafts. The simplified LOB is expected to be paired with the PPT. Further work will be done on both the detailed and simplified LOB and Commentary during the first part of 2016, in light of changes to the U.S. model LOB, which is expected to be finalized by the end of 2015.

- The guidance on the PPT generally incorporates the guidance from the 2014 deliverable and the subsequent discussion drafts. The Commentary on the PPT includes a new example related to the splitting of contracts to avoid a PE.
- The final report also confirms the specific changes recommended in the 2014 deliverable, including a provision to deny treaty benefits when payments are made to a low-taxed PE in a third jurisdiction, a minimum holding period to receive dividend withholding relief, a provision to prevent avoidance of the real property holding company provision, and a modification to the dual residence tie-breaker for entities. The recommendations also include guidance on the interaction of treaty provisions and domestic anti-abuse rules.
- Because the final recommendations include the recommendations of the 2010 report on collective investment vehicles (CIVs), no further work is anticipated on the treaty benefit of CIVs.

In order to provide clarity that tax treaties are not intended to be used to generate 'double non-taxation', Action Plan 6 has recommended changes to the Title and Preamble of the OECD Model Tax Convention supplemented by changes to relevant paragraphs of the Introduction to OECD Model Tax Convention.

Some of the tax policy considerations recommended by Action Plan 6 are existence of risk of double taxation (this being the primary tax policy concern), risk of excessive taxation that may result from high rate of withholding in the source State, protection from discriminatory tax treatment of foreign investment, greater certainty of tax treatment for taxpayers.

Action Plan 6 also states that while negotiating a tax treaty, if a country has BEPS concerns with respect to certain features of the domestic law of a prospective treaty partner (such as providing preferential tax rules) or with respect to drastic changes that might be made after the conclusion of a tax treaty, then such country may want to protect its tax base against such risks and may therefore find it useful to include in its treaties provision that would restrict treaty benefits to taxpayers benefitting from the above aspects.

The final report states that recognized pension funds will be treated as residents of the state in which they are constituted, and called for further work on the definition of a recognized pension fund. Thereafter, OECD released discussion draft that includes draft changes to Articles 3 and 4 of the OECD Model Tax Convention, and to the Commentary on these Articles, that will ensure that a pension fund is considered to be a resident of the State in which it is constituted for the purposes of tax treaties.

The final report also called for additional work to be done on the granting of treaty benefits to non-CIV funds during the first half of 2016. Pursuantly, OECD released a Public Consultation document on the treaty entitlement of non-CIV funds inviting response to the questions included in the document.

The Public Consultation document included a number of specific questions related to concerns, identified in comments received on previous discussion drafts related to the BEPS Action Plan 6 Report, as to how the new provisions included in the BEPS Action Plan 6 Report could affect the treaty entitlement of non-CIV funds as well as to possible ways of addressing these concerns that were suggested in these comments or subsequently.

International developments

BEPS Action Plan 15 called for the development of a Multilateral Instrument (MLI) to implement tax treaty-related BEPS measures. The MLI is the primary way that jurisdictions are implementing the treaty-shopping minimum standard. BEPS Action Plan 6 also called for the development of treaty provisions to prevent the granting of treaty benefits in inappropriate circumstances.

On the international front, certain countries that have started to realign their treaties with the Action Plan 6 with respect to the PPT as well as the LOB clause either through the MLI or through the bilateral tax treaty route.

With a view to assessing countries' efforts to incorporate the BEPS Action Plan 6 final recommendations, OECD released the first peer review report in February 2019 dealing with the implementation of the Action Plan 6 minimum standard on treaty shopping. The report reveals that a large majority of IF members have begun to translate their commitment on treaty shopping into actions and are in the process of modifying their treaty network.

The report includes the aggregate results of the peer review and data on tax treaties concluded by each of the 116 jurisdictions (including India) that were members of the BEPS IF on 30 June 2018. The report recognises the

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substantial progress that jurisdictions have made in 2017 and 2018 towards the implementation of the minimum standard.

The results of the peer review show the effectiveness of the MLI in implementing the treaty-related BEPS measures. It is by far the preferred tool of IF members for implementing the minimum standard.

India perspective

While addressing the situations that abuse treaty benefits, the PPT rule recommended by the BEPS Action Plan 6 suggests that anti-avoidance provisions can be triggered if 'one of the principal purposes' of an arrangement is to gain treaty benefits. Under the Indian Income-tax Act, the General Anti Avoidance Rules (GAAR) provisions introduced earlier also provided for 'main purpose or one of the main purposes' as a test to trigger the anti-avoidance rules, which, however, have been subsequently amended to limit the applicability only to cases where the 'main purpose' is to obtain the tax benefit. Thus, the PPT rule under Action 6 appears to be wider as compared to the provisions of GAAR.

To curb the practice of treaty abuse and round tripping of funds, the Indian Government has amended the India-Mauritius tax treaty by signing the protocol on 10 May 2016. The protocol, amongst other things, provides that gains from the alienation of shares acquired on or after 1 April 2017 in a company which is a resident of a state may be taxed in that state. In other words, gains from transfer of shares of an Indian resident company may be taxed in India. The protocol has also introduced a LOB clause in the tax treaty for a limited period (1.4.2017 to 31.03.2019) for taxing the gains from alienation of shares acquired during the limited period. The protocol introduces a beneficial rate of 50 percent of the domestic tax rate and full domestic tax rate on such gains from 1.4. 2019 (FY 2019-20).

India signed the MLI in 2017, listing 93 of its tax agreements. For its 93 agreements listed under the MLI, India is implementing the preamble statement (Article 6 of the MLI) and the PPT (Article 7 of the MLI). India also opted for the simplified LOB of the MLI. The agreements that will be modified by the MLI will come into compliance with the minimum standard once the provisions of the MLI take effect.

In June 2019, India has approved the ratification of MLI and deposited the ratified copy of MLI with the OECD Depository i.e. the Secretary- General of OECD along with India's final positions on MLI Articles. MLI to enter into effect for India from 1 April 2020.

Further, the Finance Act 2020 amended section 90 of the Act to include the recommendations as per BEPS Action Plan 6. The amended clause reads as follows:

“90. (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

.....

*(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, **without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory),”***

Action Plan – 7 - Preventing the Artificial Avoidance of Permanent Establishment Status

Background

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a PE to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State.

It had already been recognised way in the past that the concept of PE referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention). Nowadays it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere.

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The aim of Action Plan 7 is to develop changes to the definition of PE to prevent abuses of that threshold, including through the use of commissionaire arrangements and the specific activity exemptions to avoid PE status where core activities are involved. The OECD released an initial discussion draft on 31 October 2014 and a revised discussion draft on 15 May 2015. The revised discussion draft built on the 14 options presented in the first discussion draft and set out specific proposed changes to the PE definition in the OECD model treaty, accompanied by corresponding changes to the Commentary. In its final report, the OECD has recommended the proposed changes to the PE definition and related Commentary contained in the revised discussion draft.

- The OECD recommends an expanded scope of what is proposed to constitute a PE, focusing on the negotiation and final conclusion of contracts. An important addition to paragraph 5 is the phrase: “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.” As a result, under circumstances, also sales support and marketing type activities may constitute a PE. Furthermore, the exception for independent agents will no longer apply for companies belonging to the same group, if that person acts exclusively or almost exclusively on behalf of one or more related enterprises. A person is closely related to an enterprise if, one has control of the other or both are under the control of the same enterprise. The final report includes for this purpose cases where a person possesses directly or indirectly more than 50 per cent of the beneficial interest in the other or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or the beneficial equity interests. The OECD re-confirms that so-called limited risk distributors cannot create an agency PE under article 5, but their profits may be affected by the work on Action Plans 8-10.
- The exception for preparatory and auxiliary activities (Article 5, paragraph 4) will only apply if each activity meets the preparatory and auxiliary definition or, in the event of a combination of activities, they together can be seen to be preparatory and auxiliary in nature.
- A new anti-fragmentation rule seeks to deny the preparatory and auxiliary exception if the foreign enterprise or a related enterprise carries on related activities in the same jurisdiction and those

activities, taken as a whole, go beyond preparatory and auxiliary. Noteworthy here is that the OECD prescribes that a resident entity can be seen as a PE in the same state.

- New rules to avoid the splitting of contracts are aimed at construction activities carried out by more than one foreign entity, each for a period of less than the threshold for construction activities (generally 12 months). Rather than changing the wording of paragraph 3, the OECD aims to deal with this under the new PPT rule to be introduced following Action Plan 6.
- There will be no further rules for insurance companies selling in a state without having a PE in such state. Any changes should follow the general rules of the revised paragraphs 5 and 6 of article 5.
- The conclusion of the work on Action Plan 7 is that the existing rules of Article 7 do not require substantive modifications and guidance concerning the attribution of profits to a PE but that there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this report, in particular for PEs outside the financial sector. There is also a need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital.

Some global developments with an aim to implement the measures in the context of BEPS Action Plan 7

The option of adopting the measures that have been recommended in the BEPS Action Plan 7 on the artificial avoidance of PE are included in the MLI i.e. BEPS Action Plan 15. In June 2017, 67 countries across the globe signed the MLI and committed themselves to the various measures, BEPS Action Plan 7 related measures being one amongst them.

Changes to the PE definition developed through the work on BEPS Action 7 and included in the MLI, address the techniques used to inappropriately avoid the existence of a PE, including through the replacement of distributors with commissionaire arrangements, through strategies where contracts which are substantially negotiated in a State are not formally concluded in that State because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts in the name of a foreign enterprise claims to be an "independent agent" even

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though it is acting exclusively or almost exclusively for closely related enterprises. These changes also address the strategies based on the specific activity exceptions provided in Article 5(4) of the OECD Model Tax Convention, by restricting these exceptions to preparatory or auxiliary activities and by addressing the fragmentation of business activities between closely related enterprises.

The suggested changes require amendment of existing tax treaties. More than 85 countries have adopted the MLI paving the way for implementing the treaty-related BEPS measures and modify bilateral tax treaties in a synchronised and efficient manner.

India perspective

India has adopted the following key measures in the context of amendments to the definition of PE that have been incorporated through the MLI:

Market support arrangements-

- the scope of PE has been expanded to include agent playing principal role, leading to routine conclusion of contracts, without material modification;
- agent acting exclusively or almost exclusively on behalf of one or more closely related enterprises not to be considered independent.

Specific activity exemptions where the activity is of a “preparatory or auxiliary” character-

- activities carried out by the foreign company need to be tested on individual, as well as collective basis for meeting ‘Preparatory and auxiliary test’
- PE to be formed by disregarding fragmentation of cohesive business operations whether within entity; or within the group.

Artificial splitting-up of contracts-

- Aggregation of time spent (in excess of 30 days in the aggregate) at a building site or construction or installation project by the enterprise and connected activities carried out (during periods that exceed 30 days) by closely related enterprises at the same building site or construction or installation project during different periods of time.

It may be pertinent to note that the aforesaid provisions will only apply to a particular tax treaty entered into between India and the respective treaty

partner to the extent that India's relevant treaty partner has similarly not exercised its right of reservation, and notified India in its respective CTA.

Action 8, 9 and 10 - Aligning Transfer Pricing Outcomes with Value Creation

Action Plans 8, 9, and 10 of the BEPS Action Plan relate to a number of closely related topics. These include the development of: (i) rules to prevent BEPS by moving intangibles among group members; (ii) rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members, which will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital and to require alignment of returns with value creation; and (iii) rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.

The guidance takes the form of amendments to various chapters of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The report covers risk and re-characterisation (Chapter I of the OECD Guidelines), intra-group commodity transactions (Chapter II of the OECD Guidelines), intangibles including HTVI (Chapter VI of the OECD Guidelines), services including low value-adding intra-group services (Chapter VII of the OECD Guidelines), and cost contribution arrangements (Chapter VIII of the OECD Guidelines). The following describes the key points relevant in the Actions 8-10 report:

- Chapter I - addresses the capacity to assume and control risk, the relationship between contractual arrangements and conduct, as well as the return for low functioning or “cash box” companies. It also sets out the circumstances in which transactions that lack commercial rationality can be disregarded. Given these changes and the outputs from other actions no special measures were ultimately considered to be needed. It also contains guidance on the treatment of location savings and other market features, assembled workforce and group synergies.
- Chapter II – additions to address intra-group commodity transactions. Addresses applicable methods (generally the CUP method) and enhanced rules for application of the methods (e.g., economically relevant characteristics) to commodity transactions.

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- Chapter VI - clarifies the definition of intangibles and HTVI, discusses ownership of intangibles and transactions involving development, enhancement, maintenance, protection and exploitation (DEPME) of intangibles. The report provides supplemental guidance for determining arm's length conditions in intangible transactions.
- Chapter VII – provides guidance regarding intra-group services transactions and an elective simplified method or safe harbor for low value-adding services.
- Chapter VIII - defines CCAs, addresses the value of contributions to CCAs and addresses the substance of CCA participants. As expected, this guidance accords with the principles in Chapters I and VI to ensure that CCAs cannot be used to circumvent the new guidance relating to intangibles and risk.

In June 2018, OECD released:

- guidance for tax administrations on the application of the approach to Hard-to-Value Intangibles (HTVI) – BEPS Action Plan 8. The guidance presented the principles that should underlie the application of the HTVI approach by tax administration, with the aim of improving consistency and reduce the risk of economic double taxation. The new guidance also included a number of examples clarifying the application of the HTVI approach in different scenarios; and addressed the interaction between the HTVI approach and the access to the mutual agreement procedure under the applicable tax treaty.
- guidance on the Application of the Transactional Profit Split Method. This report contains revised guidance on the profit split method, developed as part of Action 10 of the BEPS Action Plan. The guidance provides the following indicators on when the profit split method is likely to be the most appropriate transfer pricing method:
 - Each party makes unique and valuable contributions;
 - The business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other;
 - The parties share the assumption of economically significant risks, or separately assume closely related risks.

The revised text also expands the guidance on how the profit split method should be applied, including determining the relevant profits to be split, and appropriate profit splitting factors.

Sixteen examples, including some contributed by developing country members of the OECD/G20 IF, are included to illustrate the principles discussed in the text, and demonstrate how the method should be applied in practice.

OECD undertook further work to provide guidance on transfer pricing for financial transactions, to provide both tax administrations and practitioners with the required tools to address transfer pricing issues involved in intragroup financial transactions. Thereafter a discussion draft has been released for public consultation. The discussion draft addresses the interaction between existing transfer pricing rules and the particularities of financial transactions, and provides guidance on a specific set of activities of particular complexity such as intragroup funding, guarantees and the use of so-called “captive” insurance companies.

Global developments

Many countries⁵ across the world have adopted the Transfer Pricing guidelines in the context of BEPS Action Plan 8-10 which are largely in line with the OECD guidelines.

India developments

In the context of pricing of controlled transactions involving intangibles, India does not have specific guidance on pricing of controlled transactions involving intangibles. Indian transfer pricing officers typically rely on generally accepted valuation methods in this regard.

India does not have any rules or special measures regarding HTVI. However, India is actively engaged in the post-BEPS discussions on measures to price HTVI under the aegis of Working Party 6 of OECD.

India does not have specific guidance in regard to specific to intra-group services transactions and stipulates the adoption of the Most Appropriate Method considering all relevant facts and circumstances of the case. Transfer Pricing Officers do adopt the benefits test approach and the taxpayer is expected to maintain documentation evidencing the same.

⁵ Austria, Czech Republic, Finland, Norway, Spain, etc.

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India has introduced a safe harbour rule for receipt of low-value adding intra-group service by an Indian taxpayer from its associated enterprise.

Action Plan -11 - Measuring and Monitoring BEPS

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some MNEs take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, the *Addressing Base Erosion and Profit Shifting* report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Assessing currently available data is an important part of this Action Plan. The Action Plan 11 states that improving the availability and analysis of data on BEPS is critical, including monitoring the implementation of the Action Plan. The OECD released one discussion draft under Action Plan 11 in October 2014.

The final report, amongst other things, deals with the following:

- An assessment of the existing data sources relevant for BEPS analysis. In particular, the report assesses the existing data sources relevant for analysis of BEPS and BEPS countermeasures, describes the potential criteria for evaluating available data for BEPS research and highlights the challenges and limitations of currently available data for BEPS analysis.
- Introducing six indicators to assist in tracking the scale and economic impact of BEPS over time, as well as two additional indicators that may be constructed in the future with better data.

The indicators are briefly discussed below:

The profit rates of MNE affiliates located in lower-tax countries are higher than their group's average worldwide profit rate. For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group's worldwide profit rate on average.

The effective tax rates paid by large MNE entities are estimated to be 4 to 8½ percentage points lower than similar enterprises with domestic-only operations, tilting the playing-field against local businesses and non-tax

aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.

Foreign direct investment (FDI) is increasingly concentrated. FDI in countries with net FDI to GDP ratios of more than 200 percent increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly. For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012. Royalties received by entities located in these low-tax countries accounted for 3% of total royalties, providing evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

Two additional indicators are also described that could be calculated when new data become available: a comparison of profit rates and ETRs of MNE domestic (headquarter) and foreign operations, and differential rates of return on FDI investment from special purpose entities.

- The proposed indicators aim to identify disconnects between financial and real economic activities, profit rate differentials within top global MNEs, tax rate differentials between MNEs and comparable non-MNEs, and profit shifting through intangibles and interest.
- Providing a survey of the current literature and research that measures the scale and economic impact of BEPS and BEPS countermeasures.
- Recommendations aimed at better data and tools for monitoring BEPS in the future. The list of recommendations includes, but is not limited to, a new Corporate Tax Statistics publication [which among other information would include aggregated and anonymised statistical analyses based on the data collected under the Action Plan 13 Country-by-Country (CbyC) Report] and periodic reports on the

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estimated revenue impacts of proposed and enacted BEPS countermeasures.

- While recognizing that measuring economic and revenue effects of BEPS is challenging given complexity of BEPS and existing data limitations, Action Plan 11 states that fiscal effects of BEPS are significant, basis numerous past empirical studies. As already stated earlier, the estimates for annual global revenue losses from BEPS are between USD100-240 billion at 2014 levels, which represent 4 to 10 per cent of global corporate tax revenues. These effects are found to be higher in developing countries given the greater reliance on corporate income tax revenues and often weaker tax enforcement capabilities. Besides fiscal losses, empirical analyses find that BEPS cause significant economic distortions. Furthermore, the analyses indicate that BEPS adversely impact competition between businesses, levels of debt location, location of intangible investments and causes wasteful expenditure of resources on tax engineering. However, the current analyses have found it difficult to separate effects of BEPS from real economic factors and effects of deliberate government tax policy choices.

Developments across the globe in the context of BEPS Action Plan 11

The Action Plan 11 report highlighted the lack of quality data on corporate taxation being a major limitation to the measurement and monitoring of the scale of BEPS and the impact of the OECD/G20 BEPS project.

In this context, OECD, released a report/database viz. Corporate Tax Statistics that provided internationally comparable statistics and analysis from around 100 countries worldwide on four main categories of data:

- corporate tax revenues,
- statutory Corporate Income Tax (CIT) rates,
- corporate effective tax rates and
- tax incentives related to innovation.

The OECD analysis shows that CIT remains a significant source of tax revenues for governments across the globe. In 2016, corporate tax revenues accounted for 13.3 per cent of total tax revenues on average across the 88 jurisdictions for which data is available. This figure has increased from 12 per cent in 2000.

Corporate tax revenues have also held up when considered as a percentage of GDP, where the average share increased from 2.7 per cent of GDP in 2000 to 3.0 per cent in 2016 across the jurisdictions included in the database. The OECD analysis shows a clear trend of falling statutory corporate tax rates, i.e. the headline rate faced by companies over the last two decades.

The said database is intended to assist in the study of corporate tax policy and expand the quality and range of statistical information available for analysis under the BEPS initiative. The new database aims to improve the measurement and monitoring of BEPS.

Action Plan 12 – Mandatory Disclosure Rules

The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Governments need timely access to relevant information in order to identify and respond to tax risks posed by tax planning schemes. Access to the right information at an early stage allows tax administrations to improve the speed and accuracy of their risk assessment over a simple reliance on voluntary compliance and audit. At the same time, early identification of taxpayer compliance issues also gives tax authorities more flexibility in responding to tax risk and allows tax policy officials to make timely and informed decisions on appropriate legislative or regulatory responses to protect tax revenues.

A number of countries have therefore introduced disclosure initiatives to give them timely information about taxpayer behaviour and to facilitate the early identification of emerging policy issues. These initiatives include: rulings, penalty reductions for voluntary disclosure and the use of co-operative compliance programmes and additional reporting obligations as well as mandatory disclosure regimes.

The Action Plan recognises that one of the key challenges faced by tax authorities is a lack of timely, comprehensive and relevant information on potentially aggressive or abusive tax planning strategies. The Action Plan noted that the availability of such information is essential to enable governments to quickly identify areas of tax policy and revenue risk. While audits remain a key source of information on tax planning, they suffer from a number of constraints as tools for the early detection of tax planning schemes.

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The goal of Action Plan 12 is to design mandatory disclosure rules for perceived aggressive or abusive tax planning. The OECD published a discussion draft on 31 March 2015 in which it outlined the main objectives and design principles of any mandatory disclosure regime. The OECD final report provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users.

- The recommendations seek to achieve the following key objectives:
 - To provide tax authorities with early information on potentially aggressive or abusive tax planning schemes, which may not be achieved through disclosure mechanisms already in place
 - To act as a deterrent for aggressive tax avoidance behavior, since a taxpayer is less likely to enter into a tax planning scheme knowing that the tax outcomes need to be disclosed and may subsequently be challenged by the tax administration
 - To identify abusive tax avoidance schemes, specific information about their taxpayers (users) and promoters
- Design principles of a mandatory disclosure: The report states mandatory disclosure regimes should be
 - clear and easy to understand,
 - should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration,
 - should be effective in achieving their objectives,
 - should accurately identify the schemes to be disclosed,
 - should be flexible and dynamic enough to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks), and
 - should ensure that information collected is used effectively.
- The report recommends the adoption of rules on the mandatory disclosure of aggressive tax planning arrangements by tax advisors (also called promoters in the report) and taxpayers.
- The report sets out the basic elements of disclosure regime and

alternate options that may be adopted by individual countries based on their existing legislations on various parameters [i.e., who has to report (user or promoter), what has to be reported (threshold requirements), when information should be reported etc.

- Such rules should include specific and generic hallmarks. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Specific hallmarks target particular areas of concern such as losses; establish a mechanism to track disclosures and link disclosures made by promoters and clients as identifying scheme users is also an essential part of any mandatory disclosure regime; link the timeframe for disclosure to the scheme being made available to taxpayers when the obligation to disclose is imposed on the promoter; link it to the implementation of the scheme when the obligation to disclose is imposed on the taxpayer; introduce penalties (including non-monetary penalties) to ensure compliance with mandatory disclosure regimes that are consistent with their general domestic law.
- Sanctions, especially pecuniary penalties, for non-compliance are also recommended.

International tax schemes

International schemes are more likely to be specifically designed for a particular taxpayer or transaction and may involve multiple parties and tax benefits in different jurisdictions, which can make these schemes more difficult to target with domestic hallmarks.

To overcome these difficulties, it is recommended that countries develop hallmarks that focus on the type of cross-border BEPS outcomes that cause them concern. Taxpayers that enter into intra-group transactions with material tax consequences are obliged to make reasonable enquiries as to whether the transaction forms part of an arrangement that includes a cross-border outcome that is specifically identified as reportable under their home jurisdictions' mandatory disclosure regime.

Information sharing

The expanded Joint International Tax Shelter Information and Collaboration Network (JITSIC Network) of the OECD Forum on Tax Administration provides an international platform for an enhanced co-operation and

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collaboration between tax administrations, based on existing legal instruments, which could include co-operation on information obtained by participating countries under mandatory disclosure regimes.

The Action Plan 12 also makes a reference to the Action Plan 5 (requires the compulsory spontaneous exchange of information in respect of rulings that could give rise to BEPS concerns in the absence of such exchange) and Action Plan 13 (requires MNEs to provide tax administrations with high-level global information on their global business operations and transfer pricing policies) while mentioning that a number of the transparency measures under the Action Plan include requirements related to information exchange.

Updates on mandatory disclosure rules

OECD issued new model disclosure rules that require various entities and organisations to inform tax authorities of any schemes they put in place for their clients to avoid reporting under the OECD/G20 Common Reporting Standard (CRS) or prevent the identification of the beneficial owners of entities or trusts.

The design of the model rules draws extensively on the best practice recommendations in the BEPS Action Plan 12 while being specifically targeted at the types of CRS Avoidance arrangements and opaque offshore structures.

OECD noted that the reporting and automatic exchange on offshore financial accounts pursuant to the CRS has become a reality in over 100 jurisdictions (including India). Many taxpayers that held undeclared financial assets offshore have come clean to their tax authorities in recent years, which has already led to over 85 billion of additional tax revenue.

OECD has also observed that there are persons that still, often with the help of advisors and financial intermediaries, continue to try hiding their offshore assets and fly under the radar of CRS reporting. The new rules released target these persons and their advisers, by introducing an obligation on a wide range of intermediaries to disclose the schemes to circumvent CRS reporting to the tax authorities. The new rules also require the reporting of structures that hide beneficial owners of offshore assets, companies and trusts.

Action Plan 12 seeks to balance the need for early information on aggressive tax planning schemes with the need that disclosure requirements be

appropriately targeted, enforceable and avoid over-disclosure or placing undue compliance burden on taxpayers. Several countries are considering the introduction of rules based on Action Plan 12 and the European Council has adopted a directive that require Member States to introduce mandatory disclosure rules for cross-border aggressive tax planning, offshore structures and CRS avoidance schemes. The directive incorporates the model rules set out in the OECD Report on Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures.

India perspective

The prevention measures that could lead to information being collected by the Indian tax administration consist of the advance rulings; Nil/lower tax withholding tax certificates etc. Further the Country by Country (CBC) reporting is also introduced by the Indian Government through the Finance Act which is also would facilitate information disclosure. In recent times India has also witnessed 'Tax Information Exchange Agreements' being executed with various jurisdictions.

Further, there have been several amendments made to the annual Income-tax return which requires the taxpayer to provide information regarding assets held outside India which can facilitate disclosure of such assets to the Income-tax department.

Action Plan 13 - Transfer Pricing Documentation and CbC Reporting

The rationale behind introduction of Action Plan 13 was the lack of quality data on corporate taxation which has been a major limitation for measuring the fiscal and economic effects of tax avoidance, making it difficult for authorities to carry out transfer pricing assessments on transactions between linked companies and even more difficult to carry out audits.

Action Plan 13 recognizes that enhancing transparency for tax administrations by providing them with adequate information to conduct transfer pricing risk assessments and examinations is an essential part of tackling the BEPS problem.

- The OECD recommended a three-tiered approach to documentation that includes preparing a master file, local file and CbC report.
- The master file is intended to provide a "blueprint" of the MNE group containing standardized information relevant for the MNE group. The

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local file provides additional detail on the operations and transactions relevant to that jurisdiction and the economic analyses of the intercompany transactions. Finally, the CbC report contains summary data by jurisdiction including revenue, income, taxes, and indicators of economic activity.

- The OECD has recommended that i) the CbC report be required for MNE groups with annual consolidated group revenue of more than EUR750 million; ii) will begin from MNE's fiscal year beginning on or after January 1, 2016; iii) will be filed by the ultimate parent company of the MNE in its jurisdiction (or by a surrogate parent entity); and iv) is due one year after the fiscal year end of the parent company.
- The master file and local file will be filed locally with the tax jurisdictions requiring the reports.

With regard to developments on BEPS Action Plan 13, jurisdictions have taken significant steps to introduce a framework for the filing and exchange of reports with respect to MNE groups with consolidated group revenues of at least EUR 750 million, with measures being implemented rapidly, consistently and globally. The information collected is valuable for tax administrations, and includes the amount of revenue reported, profit before income tax, and income tax paid and accrued, as well as the stated capital, accumulated earnings, number of employees and tangible assets. This will be particularly useful for developing countries that will be able to better assess the transfer pricing risks posed by some MNEs in their tax jurisdiction and make informed decisions on deploying audits which would lead to a more efficient allocation of resources.

By the time the first exchange of CbC reports, commenced in June 2018, over 1400 exchange relationships were activated, comprising those between the 70 signatories to the CbC reporting multilateral competent authority agreement (CbCR MCAA), between the 28 EU Member States, and under bilateral competent authority agreements for exchanges under double tax conventions, Convention on Mutual Administrative Assistance in Tax Matters, or tax information exchange agreements.

OECD released the first annual peer review report on the implementation of the Action Plan 13 minimum standard in May 2018. This focused primarily on the domestic legal and administrative framework for the filing of CbC reports, but also reviewed the status of a jurisdiction's exchange framework and the

measures it has in place to ensure the appropriate use of CbC reports. The report contained an assessment of the implementation of CbC reporting in 95 OECD/G20 IF members.

India update

In line with the BEPS Action Plan 13, the Finance Act 2016 introduced new provisions i.e. section 92D(4) read with section 286 in relation to master file and CbCR requirements applicable from FY 2016-17.

Master file and local file

The CbCR and Master File (MF) requirements were introduced in addition to the already existing local documentation requirements. The detailed rules with respect to CbCR and MF filing obligations were released on 31 October 2017.

India's MF deviates from the OECD MF. MF is to be filed by the tax return submission due date (30 November). MF can be prepared in English. MF is required to be filed in Form 3CEAA, comprising of Part A and Part B.

Part A of is required to be filed by all Constituent Entities (CEs) resident in India of any international group and Part B is required to be filed by entities which meet the following thresholds:

- (i) consolidated group revenue for the accounting year exceeds INR 500 crore; and
- (ii) aggregate value of international transactions during the accounting year, as per books of accounts exceeds INR50 crore, or in respect of purchase, sale, transfer, lease or use of intangible property exceeds INR10 crore.

Further, if the group has more than one CE in India, Form 3CEAB is also required to be filed at least 30 days prior to the due date of filing the MF,

CbC reporting

CbC reporting applies to MNEs with annual consolidated group revenue equal to or exceeding INR 5,500 crore in the previous year. CbC reporting applies in India from fiscal years beginning on or after 1 April 2016.

CbC report is to be filed within 12 months from the end of reporting accounting year. India has adopted the OECD's XML Schema standardized electronic format. Indian entities are allowed to act as a surrogate.

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The Indian entity with a foreign parent is required to notify the Indian authority, by filing Form 3CEAC, on or before sixty days prior to the date of furnishing CbCR.

Further, to ensure diligent compliance with the aforesaid provisions, a penalty structure has also been prescribed which is discussed as under:

- Failure to furnish information and documentation (master file) as may be prescribed in rules by the due date will attract penalty of be INR 500,000.
- Penalty for CbCR

Penalty for CbCR	Delay upto one month	Delay beyond one month	Delay in payment of penalty - after receipt of penalty order
Failure to furnish CbCR by the due date of filing of return of income	INR 5,000 per day	INR 1,50,000 + INR 15,000 per day	INR 50,000 per day
Failure to furnish additional information and documents sought by the Revenue authorities	INR 5,000 per day from the day on which the period for furnishing the information and document expires		INR 50,000 per day
Inaccurate information filed under the CbCR <i>(Penalty to be levied based on certain conditions)</i>	INR 500,000		

Action Plan - 14 - Making Dispute Resolution Mechanisms More Effective

Background

Article 25 of the OECD Model Tax Convention (OECD 2014) provides a mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or

application of the Convention on a mutually-agreed basis. This mechanism – the Mutual Agreement Procedure (MAP) – is of fundamental importance to the proper application and interpretation of tax treaties, notably to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty.

The recommendations of the Action plan

The aim of Action Plan 14 is to improve the effectiveness of the MAP in resolving treaty-related disputes. The OECD released a discussion draft on 18 December 2014 in which the OECD attempted to identify comprehensively the obstacles that prevent countries from resolving disputes through MAP and to develop possible measures to address those obstacles. The final report reflects a commitment by all countries to adhere to a minimum standard for the resolution of treaty related disputes, and establish and submit to a monitoring mechanism to ensure that the commitments embodied in the minimum standard are fulfilled. In addition, the final report identifies best practices which are complementary to the minimum standard, but are not part of it. Finally, the final report notes that while currently there is no consensus among all OECD and G-20 Countries on the adoption of mandatory binding arbitration, a significant group of countries has committed to adopt and implement mandatory binding arbitration.

- Minimum Standards – The final report identifies 17 specific measures that comprise the minimum standard and are intended to be responsive to each of the stated objectives. These elements and the objective to which they relate include:
 - Good Faith: provide access to MAP in TP cases, provide access to MAP with respect to treaty or domestic law general anti-treaty abuse rules, resolve MAP cases within an average of 24 months, commit to membership in the Forum on Tax Administration (FTA), report MAP statistics in a complete and timely manner, agree to peer review of compliance with minimum standards in the FTA, and provide transparency regarding reasons for rejecting arbitration;
 - Administrative Procedures: publish clear and easily accessible guidance and procedures for accessing and using MAP, publish MAP profiles on shared public platform, ensure that staff in charge of MAP is authorized to resolve cases, should not use revenue or audit

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adjustment based performance measures for competent authority functions, ensure adequate resources provided to the MAP function, and clarify that audit settlements do not preclude access to MAP; Countries with bilateral Advance Pricing Arrangement (APA) programmes should provide for the roll-back of APAs in appropriate cases, subject to the applicable time limits; and

- Access to MAP: inform both competent authorities of MAP requests and allow for both to provide views on whether the request should be accepted or rejected, identify in published guidance the specific information and documentation necessary to be submitted to request MAP, and include in tax treaties that agreements will be implemented notwithstanding domestic law time limits, or accept alternative provisions that limit the time for making certain adjustments to avoid late adjustments for which MAP relief is unavailable.
- In addition to the specific minimum standard, the final report identifies 11 best practices. The best practices are not considered part of the minimum standard because they have a subjective or qualitative character that is not readily monitored or evaluated, or because not all OECD and G20 countries are willing to commit to them at this stage.
- The final report notes that while currently there is no consensus among all OECD and G-20 Countries on the adoption of mandatory binding arbitration, a significant group of countries has committed to adopt and implement mandatory binding arbitration. The following countries declared a commitment to provide for mandatory binding arbitration in their bilateral treaties: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Some developments around the globe and response of OECD

The MLI deals with the treaty related minimum standard on improvement of dispute resolution (BEPS Action Plan 14). The minimum standard for dispute resolution, amongst other things, provides that countries commit to seek to resolve MAP cases within an average timeframe of 24 months. The minimum standard will ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that administrative processes promote the prevention and timely resolution of treaty-related disputes.

The implementation of the minimum standard on dispute resolution will be evaluated through a monitoring mechanism in order to ensure that the commitments embodied in the minimum standard are effectively satisfied.

As part of continuing efforts to improve the international tax framework and with a view to improve dispute resolution mechanisms, OECD has released 9 batches (consisting of 72 countries) of stage 1 and 2 peer review reports as of 30 August 2019.

Each report assesses a country's efforts to implement the Action Plan 14 minimum standard as agreed to under the OECD/G20 BEPS Project.

Peer review reports continue to demonstrate that countries remain dedicated to turning the political commitments made by members of the OECD/G20 IF on BEPS into measureable, tangible progress. Countries from previous batches are already working to address deficiencies identified in their respective peer review reports.

India update

The measures adopted by India in the context of BEPS Action Plan 14 on Dispute resolution and Mandatory Binding Arbitration through the MLI are discussed below:

Dispute Resolution

As far as presenting the case to the competent authorities is concerned, India has opted for the option for the cases to be presented by the taxpayer only in the country of its residence.

With regard to time limit for presenting the case for Mutual Agreement Procedure (MAP), India has agreed with the prescribed time limit of three years.

India has reserved its right for the applicability of the provisions relating to corresponding adjustments not to apply to its CTA that already contain such a provision.

Mandatory Binding Arbitration

Whereas India has opted out of the arbitration process, 25⁶ of the 7 June signatories have signed up for the arbitration provisions in the MLI. This will lead to the introduction of arbitration to over 150 existing tax treaties.

⁶ Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, the Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the U. K.

Action Plan 15 - Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. As a result, some features of the current bilateral tax treaty system facilitate BEPS that need to be addressed. Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Even where a change to the OECD Model Tax Convention is consensual, it takes a substantial amount of time and resources to introduce it into most bilateral tax treaties.

As a result, the current network is not well-synchronised with the model tax conventions, and issues that arise over time cannot be addressed swiftly. Without a mechanism to swiftly implement them, changes to models only make the gap between the content of the models and the content of actual tax treaties wider. This clearly contradicts the political objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have agreed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

The purpose of Action Plan 15 is to streamline the implementation of tax treaty-related BEPS measures through a multilateral instrument (MLI) to amend existing bilateral tax treaties. The OECD issued a report on 18 September 2014 in which it concluded that a MLI is desirable and feasible and would be negotiated through an international conference open to G20 countries, OECD members and other interested countries. On 6 February 2015, the OECD published a mandate with respect to the process for developing the MLI. On 27 May 2015, an ad hoc group was established to develop the MLI. The ad hoc group was open to all interested countries on an equal footing.

The MLI is targeted to coexist with the existing bilateral tax treaty network. Like existing tax treaties, this instrument would be governed by international law and would be legally binding on the parties. The MLI will modify a limited number of provisions common to most existing bilateral treaties, and would, for those treaties that do not already have such provisions, add new provisions specifically designed to counter BEPS. It could also clarify the

compatibility with tax treaties of other anti-BEPS measures developed in the course of the BEPS Project. The MLI is accompanied by an explanatory report to facilitate the implementation of the provisions contained therein.

The need and objectives of the MLI are as follows:

Need of the MLI –

- BEPS project recommended changes in tax treaties
- Carrying out large scale changes on a treaty-by-treaty basis would have been time consuming and may have led to inconsistencies across treaties

Objectives of the MLI -

- Single instrument that modifies bilateral tax treaties in a synchronised, fast and consistent manner
- One negotiation, one signature, one ratification
- The basic framework of the MLI is as follows: -
- Legal Status - It is a parallel document. It needs to be read with existing tax treaties. It does not replace the tax Treaties and is read in addition to the tax Treaties
- Covered Tax Agreements (CTA) - Notified tax treaties by each party to MLI
- Minimum Standard - No option to opt out of minimum standards except in limited cases. Every signatory to the MLI is required to compulsorily opt for the Minimum standard of the MLI (Article 6 - Preamble of a Covered Tax Agreement, Article 7 – Prevention of Treaty Abuse, Article 16 – Mutual Agreement Procedure).
- Notification – A signatory to the MLI has to make a notification for a particular clause to be applicable to its chosen set of CTAs
- Reservation – A signatory to the MLI has to make a reservation for opting out of a provision or non-applicability to specified CTAs.

Date of Entry into Force

- For first 5 jurisdictions who deposit their ratified copy of MLI with OECD - MLI to come into force on the first day of the month following the expiry of 3 calendar months from date on which 5th Signatory has deposited its instrument for ratification. From this date, all 5

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signatories become 'parties' to the MLI and shall be bound by it (The first 5 signatories of the MLI are Republic of Austria, Isle of Man, Jersey, Poland and Slovenia).

- For other jurisdictions - First day of the month after the expiry of 3 months from the date of deposit of its instrument of ratification.

Date of Entry into effect

Computed from the latest date of Entry into force for each of the treaty partners of a CTA is referred as "relevant date".

- Provisions related to withholding taxes - 1st day of next calendar year that begins on or after the relevant date
- Provisions related to other taxes - Taxable period that begins on or after expiry of 6 calendar months from the relevant date

It may be noted that there is an option to replace "calendar year" with "taxable period" for purpose of its own application. India has opted for such replacement.

A recent success story: the Convention on Mutual Administrative Assistance in Tax Matters

The Convention on Mutual Administrative Assistance in Tax Matters (Convention) was opened for signature by the member states of the Council of Europe and the OECD in 1988, entered into force in 1995, and had only 14 signatories as of 2009. As of 3 July 2014, 66 countries, including all G20 countries, had signed the amended Convention, and 14 jurisdictions were covered by territorial extension. The Convention – a single multilateral legal instrument – performs functions that would have otherwise required negotiating over 1800 new bilateral agreements.

As on April 2019, 128 jurisdictions (including India) participated in the Convention, including 17 jurisdictions covered by territorial extension*. This represents a wide range of countries including all G20 countries, all BRICS, all OECD countries, major financial centres and an increasing number of developing countries.

Response of jurisdictions to Action Plan 15 – MLI signed by countries across the world

On 7 June 2017, 67 countries signed the MLI to implement tax treaty related measures, developed through the BEPS Action Plans, in the existing bilateral tax treaties in a synchronized and efficient manner.

The MLI was developed by a group of over 100 countries and jurisdictions, including many developing countries. Developing countries showed great interest in signing the MLI. Many of them however needed more time to complete the domestic procedures for Signatories. The MLI is a flexible instrument that modifies tax treaties (CTA) according to a jurisdiction's policy preferences with respect to the implementation of the tax treaty-related BEPS measures.

The MLI covers the treaty-related minimum standards that were agreed as part of the BEPS Package in November 2015 and to which all countries and jurisdictions within the IF on BEPS have committed. These minimum standards relate to the prevention of treaty abuse (BEPS Action 6) and the improvement of dispute resolution (BEPS Action 14). Where an MLI provision reflects an agreed BEPS minimum standard, a jurisdiction must meet the minimum standard when signing the MLI. Certain elements of these minimum standards can, however, be met in different ways provided for in the MLI.

India update

India, amongst 67 countries, signed the MLI in Paris on 7 June, 2017 to implement tax treaty related measures to prevent BEPS. The MLI came into force in India from 1 October 2019 and will be effective from 1 April 2020.

Some of the key provisions that India has adopted through the MLI are discussed below (other provisions of the MLI that dealing with treaty abuse, artificial avoidance of PE and dispute resolution have been discussed under the respective BEPS Action Plans in the preceding paragraphs:

- *Dual Resident Entities:*

Article 4 is intended to modify the tie-breaker test under treaties for persons other than individuals. It provides that in cases where a person is a resident of more than one contracting state, its residency shall be determined by means of mutual agreement of the competent authorities of both the countries. In such cases, the competent authorities shall have regard to the place of effective management, the place of incorporation or other relevant factors. More importantly, it provides that in the absence of any agreement between the competent authorities, the dual-resident entity shall not be entitled to any relief or exemption from tax under the tax treaty, except as agreed by the competent authorities.

India has not made any reservation in respect of this Article.

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- *Dividend Transfer Transactions*

India has opted for the provision relating to the minimum shareholding to be met throughout 365 days for beneficial dividend tax rate. However, its applicability to India's treaties will depend on whether its treaty partners have also chosen to adopt these provisions.

India has reserved the applicability of this provision in the case of Portugal as there already exists a minimum holding period longer than the 365 day period mentioned in Article 8. India has further notified 21 countries where the restriction of the holding period has not been prescribed. Some of them being Canada, Denmark, Qatar, Italy, Singapore and U.S.A.

- *Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property*

India has opted to adopt both the provisions relating to taxability of capital gains in the source state which provides that the gains would be taxable if value threshold is met at any time during 365 days preceding alienation (including alienation of interest in a trust/partnership). However, its applicability to India's tax treaties will depend on whether its treaty partners have also chosen to adopt these provisions.

Synthesised Text

OECD also released Guidance for the development of 'Synthesised texts' to facilitate the interpretation and application of tax treaties modified by the MLI. This Guidance provides suggestions to parties to the MLI for the development of documents they could produce to help users of the MLI to understand its effects on tax treaties.

The objective is to present in a single document and for each CTA: the text of a CTA, including the text of relevant amending instruments; the elements of the MLI that have an effect on the CTA as a result of the interaction of the MLI positions of its contracting jurisdictions; and information on the dates on which the provisions of the MLI have effect in each contracting jurisdiction for the CTA. Such documents would be referred to as 'synthesised texts'.

Recently, India has released the synthesised text of its treaty with several countries namely Australia, Austria, Belgium, Finland, Georgia, Ireland, Japan etc.

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Withholding tax rates for various kinds of income viz. royalty / FTS, dividend and Interest with select countries

Country	Royalty	Fee for Technical Services	Dividend	Interest
Albania	10%	10%	10%	10% ^
Armenia	10%	10%	10%	10% ^
Australia	10%/15% (Note 1)	10%/15% (Note 1)	15%	15%
Austria	10%	10%	10%	10% ^
Bangladesh	10%	No specific article	- 10% (if at least 10% of the capital of the company paying the dividend is held by the recipient company) - 15% in all other cases	10% ^
Belarus	15%	15%	- 10% (if at least 25% of the capital of the company paying the dividend is held by the recipient company) - 15% in all other cases	10% ^
Belgium	10%	10%	15%	15% (10% rate applies if loan is granted by a bank)
Bhutan	10%	10%	10%	10% ^
Botswana	10%	10% (Article reads as Technical fees)	- 7.5% (if shareholder is a company and holds at least	10% ^

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Country	Royalty	Fee for Technical Services	Dividend	Interest
			25% shares in the investee-company) - 10% in all other cases	
Brazil	15% / 25% (Note 2)	15%	15%	15% ^
Bulgaria	15% / 20% (Note 3)	20%	15%	15% ^
Canada	10% / 15% /20% (Note 4)	10% / 15% /20% (Note 4)	- 15% (if at least 10% of the voting powers in the company, paying the dividends, is controlled directly indirectly by the recipient company) - 25%, in other cases	15%^
China	10%	10%	10%	10% ^
Columbia	10%	10%	5%	10% ^
Croatia	10%	10%	- 5% (if at least 10% of the capital of the company paying dividend is held by the recipient company) - 15%, in all other cases	10% ^
Cyprus	10%	10%	- 10%	10% ^
Czech Republic	10%	10%	10%	10% ^
Denmark	20%	20%	- 15% (if at least 25% of the shares of the company paying	- 10% if loan is granted by bank;

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Country	Royalty	Fee for Technical Services	Dividend	Interest
			the dividend is held by the recipient company) - 25%, in other cases	- 15% for others ^
Estonia	10%	10%	10%	10% ^
Ethiopia	10%	10%	7.5%	10% ^
Fiji	10%	10%	5%	10% ^
Finland	10%	10%	10%	10% ^
France	10%	10%	10%	10% ^
Georgia	10%	10%	10%	10% ^
Germany	10%	10%	10%	10% ^
Hong Kong	10%	10%	5%	10%
Hungary	10%	10%	10%	10% ^
Indonesia	10% (Note 5)	10%	- 10%,	10% ^
Iceland	10%	10%	10%	10% ^
Ireland	10%	10%	10%	10% ^
Israel	10%	10%	10%	10% ^
Italy	20%	20%	- 15% if at least 10% of the shares of the company paying dividend is beneficially owned by the recipient company; - 25% in other cases	15% ^
Japan	10%	10%	10%	10% ^
Jordan	20%	20%	10%	10%
Kazakstan	10%	10%	10%	10% ^
Kenya	10%	10% (Article reads as Technical	10%	10%

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Country	Royalty	Fee for Technical Services	Dividend	Interest
		Management and professional fees)		
Korea	10%	10%	- 15%	- 10%
Kuwait	10%	10%	10% ^	10% ^
Kyrgyz Republic	15%	15%	10%	10% ^
Latvia	10%	10%	10%	10% ^
Libya	Royalty taxable in state where it arises	No specific article	Dividends taxable in country where payer company is registered	Interest taxable in state where it arises
Lithuania	10%	10%	- 5% if at least 10% of the capital of the company paying the dividend is held by the recipient company - 15%, in all other cases	10% ^
Luxembourg	10%	10%	10%	10% ^
Macedonia	10%	10%	10%	10%
Malaysia	10%	10%	5%	10% ^
Malta	10% (Note 6)	10% (Note 6)	10%	10% ^
Mongolia	15%	15%	15%	15% ^
Mauritius	15%	10%	- 5%, if at least 10% of the capital of the company paying the dividend is held by the recipient company - 15%, in other cases	7.5% Exempt if derived and beneficially owned by any bank carrying on bona fide banking business (exemption to

Annexure A

Country	Royalty	Fee for Technical Services	Dividend	Interest
				apply only if such interest arises from debt-claims existing on or before 31 March, 2017).
Montenegro	10%	10%	- 5%, if at least 25% of the capital of the company paying the dividend is held by the recipient company - 15%, in all other cases	10% ^
Myanmar	10% (Note 7)	No specific article	5%	10% ^
Morocco	10%	10%	10%	10% ^
Mozambique	10%	No specific article	7.5%	10% ^
Namibia	10%	10%	10%	10% ^
Nepal	15%	No specific article	- 5%, if at least 10% of shares are held by the recipient company - 10%, in all other cases	10% ^
Netherlands	10%	10%	10%	10% ^
New Zealand	10%	10%	15%	10% ^
Norway	10%	10%	10%	10% ^
Oman	15%	15%	- 10%, if at least 10% of shares are held by the recipient company; - 12.5%,	10% ^

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Country	Royalty	Fee for Technical Services	Dividend	Interest
			in other cases	
Philippines	15% (Note 8)	No specific article	- 15%, if at least 10% of the shares of the company paying the dividend is held by the recipient company; - 20%, in other cases	- 10%, if interest is received by a financial institution or insurance company; - 15% in other cases [^]
Poland	15%	15%	10%	10% [^]
Portuguese Republic	10%	10%	- 10%, if at least 25% of the shares of the company paying the dividend is held by a recipient company for a uninterrupted period of 2 years prior to the date of payment of the dividend - 15%, in other cases	10%
Qatar	10%	10%	- 5%, if at least 10% of the shares of the company paying the dividend is held by the recipient company; - 10%, in other cases	10% [^]
Romania	10%	10%	10%	10% [^]
Russian Federation	10%	10%	10%	10% [^]

Annexure A

Country	Royalty	Fee for Technical Services	Dividend	Interest
Saudi Arabia	10%	No specific article	5%	10% ^
Serbia	10%	10%	- 5%, if recipient is company and holds 25% shares; - 15%, in any other case	10% ^
Singapore	10%	10%	- 10%, if at least 25% of the shares of the company paying the dividend is held by the recipient company; - 15%, in other cases	- 10%, if loan is granted by a bank or similar institute including an insurance company; - 15%, in all other cases
Slovenia	10%	10%	- 5%, if at least 10% of the shares of the company paying the dividend is held by the recipient company; - 15%, in other cases	10%
South Africa	10%	10%	10%	10% ^
Spain	10% / 20% (Note 9)	20%	15%	15% ^
Sri Lanka	10%	10%	7.5%	10% ^
Sudan	10%	10%	10%	10% ^
Sweden	10%	10%	10%	10% ^
Swiss Confederati	10%	10%	10%	10% ^

Basics of International Taxation

Country	Royalty	Fee for Technical Services	Dividend	Interest
on				
Syrian Arab Republic	10%	No specific article	- 5%, if at least 10% of the shares of the company paying the dividend is held by the recipient company; - 10%, in other cases	10% ^
Taipei	10%	10%	12.5%	10%
Tajikistan	10%	No specific article	- 5%, if at least 25% of the shares of the company paying the dividend is held by the recipient company; - 10%, in other cases	10% ^
Tanzania	10%	No specific article	- 5% (if at least 25% of the shares of the company paying the dividend is held by the recipient company) - 10%	10%
Thailand	10%	No specific article	10%	10%
Trinidad and Tobago	10%	10%	10%	10%
Turkey	15%	15%	15%	- 10% if loan is granted by a bank or a similar

Annexure A

Country	Royalty	Fee for Technical Services	Dividend	Interest
				financial institution, etc.; - 15% in other cases ^
Turkmenistan	10%	10%	10%	10% ^
Uganda	10%	10%	10%	10% ^
Ukraine	10%	10%	- 10% (if at least 25% of the shares of the company paying the dividend is held by the recipient company) - 15%, in other cases	10% ^
United Arab Emirates	10%	No specific article	10%	- 5% if loan is granted by a bank/similar financial institute; - 12.5%, in other cases
United Mexican States	10%	10%	10%	10% ^
United Kingdom	10% /15% (Note 10)	10% /15% (Note 10)	15%/10%*	- 10%, if interest is paid to a bank; - 15%, in other cases ^
United States	10% /15% (Note 10)	10% /15% (Note 10)	a) 15% (if at least 10% of the voting	- 10% if loan is

Basics of International Taxation

Country	Royalty	Fee for Technical Services	Dividend	Interest
			stock of the company paying the dividend is held by the recipient company)# b) 25% in other cases#	granted by a bank/similar institute including insurance company; - 15% for others
Uruguay	10%	10%	5%	10% ^
Uzbekistan	10%	10%	10%	10% ^
Vietnam	10%	10%	10%	10% ^
Zambia	10%	10% (Article reads as Management and Consultancy fees)	- 5%, (if at least 25% of the shares of the company paying the dividend is held by a recipient company for a period of at least 6 months prior to the date of payment of the dividend) - 15% in other cases	10% ^

The rates given in the above table are based on existing rates given in the tax treaties. The same may change in case of tax treaties where Most Favoured Nation (MFN) clause exist.

Footnote (Dividend / Interest):

^ Dividend / Interest earned / derived / beneficially owned by the Government and certain specified institutions, inter-alia, Reserve Bank of India in some cases is exempt from taxation in the country of source (subject to certain conditions).

**(a) 15 per cent of the gross amount of the dividends where those dividends are paid out of income (including gains) derived directly or indirectly from immovable property within the meaning of Article 6 by an investment vehicle which distributes most of this income annually and whose income from such immovable property is exempted from tax;*

(b) 10 per cent of the gross amount of the dividends, in all other cases

Sub-paragraph (b) and not sub-paragraph (a) shall apply in the case of dividends paid by a United States person which is a Regulated Investment Company. Sub-paragraph (a) shall not apply to dividends paid by a United States person which is a Real Estate Investment Trust, and sub-paragraph (b) shall only apply if the dividend is beneficially owned by an individual holding a less than 10 per cent interest in the Real Estate Investment Trust. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Notes (Royalty / FTS):

1. *Australia - The lower rate applies to payments for the use of or the right to use or forbearance of the use or right to use, any industrial, commercial or scientific equipment, the rendering of any ancillary technical or consultancy services. Different rates applied during the first 5 years of the treaty.*
2. *Brazil - The higher rate applies to royalties for the right to use trademarks.*
3. *Bulgaria – Lower rate applies in case of royalties related to copyrights of literary, artistic or scientific work other than cinematograph film or films or tapes used for radio or television broadcasting*
4. *Canada – 10% rate applies to payments for the use of, or the right to use, any industrial, commercial or scientific equipment or related services and for included services that are ancillary and subsidiary thereto. Also, higher rate (15% / 20%) applies to payment of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematography films or work on film tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof or fees for included services. Different rates applied during the first 5 years of the treaty.*
5. *Indonesia – As per new treaty which is effective in India from 1 April 2017, rate of 10% applies.*
6. *Malta - The protocol to treaty states that the provisions of articles 6 to 22 (i.e. including provisions on maximum withholding rates for dividends, interest and royalties/ Fees for technical services) of the tax treaty do not apply to persons or companies enjoying special fiscal treatments or exemptions under specific Maltese laws.*

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7. *Myanmar - The treaty provides that the provisions of the domestic law of a contracting state will prevail over the provisions of the treaty if they are more beneficial to a resident of the other Contracting State.*
8. *Philippines - 15% applies, in the case of India, where royalties are payable by an enterprise in pursuance of any collaboration agreement approved by the government of India; otherwise the domestic rate applies.*
9. *Spain - The lower rate applies to the use of, or the right to use, industrial, commercial or scientific equipment. For others, (fees for technical services and other royalties) 20% applies.*
10. *United Kingdom and United States of America – The rate of 15% applies to payment of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematography films or work on film tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience and fees for technical services ancillary or subsidiary to this and FTS which make available technical knowledge, experience etc. and transfer of technical plan or technical design. 10% applies in case of use or the right to use any industrial, commercial or scientific equipment and fees for technical services ancillary or subsidiary to this.*

Annexure B

SYNOPSIS OF SOME IMPORTANT JUDGEMENTS AND ADVANCE RULINGS

Permanent Establishment

1. AAR P. No. 11 OF 1995 [1997] 228 ITR 55 (AAR)

The applicant was a company incorporated in Singapore; hence a resident of Singapore. During the year ended 31 March 1995, it entered into two contracts, namely, X pipeline project and Y trunk pipeline project with ABC for providing services related to burial of pipelines off shore in India. The work executed by the applicant was in the nature of a turnkey sub-contract since the main contract from the ONGC was obtained by XYZ. This contract among other things envisaged installation of pipeline crossing free span rectification works, sub-sea welding, submarine cables, pipeline rigging, testing, drying and so on. The task also included mobilization and demobilization, pre-trenching survey. Part of the job was sub-contracted by XYZ to ABC. ABC in turn further sub-contracted the job of burial of pipeline to the applicant. As the contract with the applicant was in the nature of turnkey sub-contract, all marine vessels, personnel and equipments were provided by the applicant.

The duration of the two contracts was for 7 days and 39 days respectively. The activities under the contract were performed in Indian territory. The questions raised before the AAR were:

1. Whether the revenues earned by the applicant (tax resident of Singapore) from the contracts entered into with ABC during the previous year ended 31 March 1995 were liable to tax in India in view of the DTAA between India and Singapore.
2. Whether the specific provisions of the DTAA override the general provisions of the Act

The AAR held that the specific provisions of the DTAA override the general provisions of the Act which was now a settled law. This issue was not contested by the department either.

However, the tax authorities contended that the income was taxable in India as the applicant had a PE in India in terms of clause (f) of para 2 of article 5 of the DTAA, which reads as “a mine, an oil well, a quarry, or any other place

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of extraction of natural resources". It maintained that the installation work was in fact carried out by the ABC and the applicant was awarded only a part of the work by the ABC. Hence, it cannot be said that the installation work was carried out by the applicant. According to the department, oil as well as gas, has specifically been covered by the DTAA in clause (f) para 2 of Article 5.

The AAR did not accept the contention of the tax authorities and held that the applicant did not have a PE in India as the applicant's case fell within Para 3 of Article 5 of the DTAA and not clause (f) of Para 2 of Article 5 as contended by the tax authorities, as the applicant was engaged in an installation and assembly project which pertained to the burial of pipelines in the seabed. Such activities are covered by para 3 of the Article 5 of the DTAA, which reads, as "A building site or construction, installation or assembly project constitutes a permanent establishment only if it continues for a period of more than 183 days in any fiscal year". Para 3 of Article 5 permits such projects to be treated as PE only if the duration of the project exceeds 183 days in any fiscal year. In the instant case, as the applicant worked on the project only for 7 days and 39 days respectively no PE was constituted in India.

Article 7 of the DTAA dealing with profits of enterprise, permits the taxation of resident of Singapore on the profits attributable to a PE in India. In the present case, as there was no PE under the DTAA the applicant was held to be not liable to tax in India although the applicant earned profits on the projects carried out in the Indian territory.

2. AAR P. No.13 OF 1995 [1997] 228 ITR 487 (AAR) (Bechtel)

ABC a company of France having worldwide affiliates provided services to its clients on turnkey basis and on specific assignment basis in the diverse fields covering (a) transfer of licensed technology, (b) basic engineering designs, (c) detailed engineering designs, (d) project and construction management services, (e) buying services, (f) start-up technical assistance and (g) operational services.

ABC was to be awarded a contract by an India company X in connection with X's plan to set up a manufacturing plant in India. Later the scope of work was widened to include setting up of another industrial complex at the same place for another Indian company, Y a sister concern of X. ABC would be responsible for all the services to X and Y (Indian companies) on a single point responsibility basis though it might be required to procure the services

from third parties. ABC would be operating from its Head Office in France as also from its project offices in India. It was to employ 200 to 400 employees in India and about 800 employees outside India. The work to be done by ABC for X and Y were covered by the following seven separate agreements:-

- (a) Umbrella Services Agreement (USA)
- (b) Licence and Basic Engineering Agreement (LBEA)
- (c) Engineering Services Agreement (ESA)
- (d) Equipment Supply Agreement (SA)
- (e) Buying Services Agreement (BSA)
- (f) Site Services and Assistance Agreement (SSA)
- (g) Project Management Services Agreement (MSA)

ABC could get part of the work done on sub-contract basis through their affiliate offices/third parties keeping the overall responsibility with them. Some activities will be done in India and some others will be performed outside India.

DTAA between India and France came into force on August 1, 1994. A protocol entered into between the two countries, at the time of appending signatures to the convention, added further provisions forming part of the convention and relied upon by the applicants.

There were in all 13 Questions raised before the AAR the crux of the issue was on the taxability of the applicant in India. The main questions are discussed below:

- Q.2. Whether project office and site office of ABC in India will constitute a permanent establishment under DTAA?
- Q.3. Whether the payments under the agreements are in the nature of "royalty" and "FTS" under the DTAA?
- Q.4. Whether the royalties and technical fees received by ABC under the contract in respect of its activities outside India is effectively connected with the P.E. in India?
- Q.5. Whether the ABC is the beneficial owner of licence technology and basic engineering procured by it from its affiliates and/or third parties?

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- Q6. Whether ABC is the *beneficial* owner under DTAA in respect of engineering services and buying services sub-contracted by it to its affiliates/third parties?
- Q.7. Whether payments under agreements are liable to tax as "royalties and FTS" under the DTAA or under the head "business profits"? and
- Q.8. Whether in terms of article 7.1 and 7.2 (business profits) read with paragraph 3 of the Protocol to DTAA, the profits attributable to activities inside India alone will be liable to tax in India?
- Q.12. Whether head office of ABC would be liable to withhold taxes under the Income-tax Act of India in respect of payments made to the foreign suppliers (including its affiliates)?

With respect to Q.2, the AAR observed that the concept of PE had impact not only because of the time element but, also because of the connection of the profits to be taxed with the PE, both aspects had to be looked at as a whole. In the case under consideration once ABC got the contracts it would set up office and the profit-earning activities would start. In view of this and the long duration of the contract (28 to 30 Months) ABC would have a PE for the purpose of taxation of income from the contract.

With respect to Q.3 and Q.4 the AAR observed that of the seven contracts five, provided for payments to ABC as a consideration for use of patenting trademarks, designs, models, etc (belonging to ABC or acquired by it) or for information concerning industrial, commercial or scientific experience or consideration for managerial, technical consultancy services. They are in the nature of royalty/FTS under Article 13.3 and 13.4. They also answer to the description "business profits" assessable under Article 7. In the words of the AAR "There is no incompatibility between recognising the receipts as royalties and fees' for technical services - which they are under the Agreements - and looking upon them also as the profits of business assessable under Article 7".

For the activities outside India, which were meant for installation of the manufacturing plant and industrial complex in India, were integrally connected with the project of X & Y. The AAR observed, "All the outside activities are directed towards the installation of the manufacturing plant and industrial complex in India. Though carried out elsewhere, they are integrally connected with the project in India. The designs, basic engineering services and other services are based on information collected in India and the use of

the process and technologies have to be adapted to the needs of, and prove workable in, Indian conditions. The P.E. in India has an undoubted voice over the outside activities as well and the royalties and fees in question could not but be described as effectively connected with it.”

With respect to Q.5 and Q.6 the AAR held that ABC used its own existing expertise, to modify, the technology got from affiliates and/or third parties to suit the requirements of X & Y under Indian conditions. ABC was not merely a post office nor as a mere go-between; but applied the technology in the performance of contract as its own under a single contract and is responsible for the performance. Therefore, ABC was the *beneficial* owner under DTAA in respect of engineering services sub-contracted by it to its affiliates/third parties.

With respect to Q.7 and Q.8 the AAR observed that these were the crux of the whole issue. The AAR held that the said payments were taxable under Article 7 read with Article 13(b) of the DTAA. In view of the Protocol signed with France, Article 13(6) lifts out of the purview of Article 13 and transposes all payments received as royalties or technical fees, which are effectively connected with the PE, to Article 7 (profits attributable to PE). Article 7 however provides for a bifurcation of the profits between attributable to India and outside India. What is assessable under Article 7, is not the whole of such royalties / technical fees, but only the profits attributable to the PE. Clause 3 of the Protocol then steps in to clarify that profits attributable to PE can only mean those attributable to the "activities in India" and none others. As a result, royalty and technical fees received for activities outside India though effectively connected with the PE would not be covered, thanks to the Protocol.

The words "in accordance with the provisions of and subject to the limitations of the taxation laws of the Contracting State" used in Article 7.3(a) of the DTAA, would attract, in the computation of the profits under Article 7, the limitations and restrictions not merely of section 44C of the Act but also of all other provisions contained in the Act as well.

The AAR also held that payments made to head office for technology and basis engineering services were not deductible as reimbursement expenses as ABC was obliged under the contract to provide the most updated services which may be acquire or generate from time-to-time, the technology acquired by ABC may be modified/refined over a period of time. The payments made

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by X and Y to ABC are for technology perfected by ABC to suit Indian conditions for X and Y. Hence, such payments are not reimbursement of payments to ABC - but to ABC in its own right. In view of Article 7(3) (b) payments by PE to Head Office will not be deductible in computing the profits of PE in India.

With respect to Q.12 the Authority considered the issue at length and observed that the Act imposes an obligation on the head office of ABC to withhold tax on payments made to foreign suppliers under Section 9(1)(vi)(c) of the Act as the payment were being made for property/services to be utilised in a business in India. However, the AAR further observed that the DTAA required another condition to be fulfilled for the payment to get taxable in India i.e. they must be borne by the PE in India as the AAR had already held that the head office was the beneficial owner of the royalties and they were not borne by the PE, to be allowed as a deduction, this condition was not fulfilled and therefore held that, such payments cannot be deemed to accrue or arise in India. ABC may use the technology so acquired anywhere in the world. Hence, ABC would not be liable to withhold taxes under the Act in respect of payments in question.

The AAR further held that the taxability under the head "business profits" or under Section 115A of the Act would depend upon various facts:

- (a) If approval of Government is not received under Section 115 A of the Act, the profits of the PE would be computed in a normal manner and tax levied as applicable to a foreign company.
- (b) If contracts/agreements are approved by the Government of India under Section 115A of the Act, relating to royalties and FTS, they would be taxed @ 30percent on gross and for the balance at the rate as applicable to a foreign company.
- (c) Payments to ABC in consideration of services relating to construction, assembly or like projects the same would not be covered by Section 44D /115A of the Act; and only net receipts after deducting expenses under Section 28 to 44C or 57 of the Act will be assessable to tax as applicable to a foreign company. This is so because "site services and assistance agreement" as well as the "project management services agreement" relate to the assembly and construction of the manufacturing plant and the industrial complex to be set up by ABC for X and Y.

The consideration stipulated for these agreements will, therefore, fall outside the purview of the definition of "fees for the technical services" under Explanation 2 to section 9(1) (vii) of the Act which is also in tune with the DTAA read with the Protocol.

3. N.V. JAN DENUL v. CIT [1999] 236 ITR 489 (AAR)

The applicant was a company incorporated in Belgium and was engaged in the business of dredging and marine contracting. The control and management of the affairs of the company were wholly situated outside India and the company has no branches in India. The applicant was awarded a contract by Chennai Port Trust for dredging "Ennore Coal Port Project" at an approximate contract of INR 84,791,875. The applicant opened a temporary project office in India for the purpose of execution of the project with RBI's permission. The applicant had to deploy from abroad its dredgers, survey equipment, boats, computers, technical people and other plant and machinery relevant to execute the said contracts.

The applicant was a 'Non Resident' under Section 6(3) of the Act as the control and management of its affairs was situated outside India. Read with Article 4(1) of DTAA between India and Belgium the applicant was a resident of Belgium.

There were in all 9 questions which were raised before the AAR however the crux of the issue revolved around whether the applicant had a PE and whether the provisions of Section 44BBB of the Act would be applicable; the main questions were, the balance questions generally were on the computation of income if any to be done:

- (a) Whether, on the fact and in the circumstances, the applicant can be said to have a PE in India?
- (b) Without prejudice to the above, whether, on the facts and in the circumstances, the rationale behind the provisions of Section 44BBB of the Act would be applicable in the case of the appellant and a sum equal to ten per cent of the contract amount as and when paid shall be deemed to be the profits and gains chargeable under the head 'Profits and gains of business or profession'?
- (c) Without prejudice to the facts and in the circumstances the amount of taxable profit could be determined by AAR at a fixed percentage of the gross receipts based on the applicant's past profitability statements

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and other relevant factors, either assessable in the year of completion of the contract or year wise?"

The AAR observed that the whole issue revolved around the main question raised by the applicant i.e. whether the provision of Section 44BBB of the Act is applicable in its case. The AAR observed that the contract obtained by the applicant will go on for a number of years. This contract has been given to the applicant in connection with the turnkey power project, which has been approved by the Central Government. Section 44BBB of the Act opened with a non-obstante clause which read as under "Notwithstanding anything to the contrary contained in Section 28 to 44AA of the Act, in the case of an assessee, being a foreign company, engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning thereof, in connection with a turnkey power project approved by the Central Government....."

The AAR held that it would be more advantageous for the tax authorities as well as the applicant to proceed with the assessment of the profits made by the applicant by having recourse to Section 44BBB of the Act. On the facts as stated by the applicant, Section 44BBB of the Act was applicable. It was therefore, held that the other questions need not be answered.

4. ARR No. 296 of 1996 - (TVM v. CIT) [1999] 237 ITR 230 (AAR)

The applicant company TVM Limited ("TVM") was incorporated in Mauritius on 23 May 1996. The applicant had five shareholders which are companies (corporates as shareholders) and each one of them had relevant experience in contributing to making of presentation of programmes produced for broadcast. A Company by name T.V. India Ltd. ("TVI") had been incorporated in India with the same set of shareholders on 6 March 1995, with identical proportion of shareholding as TVM Ltd. The directors of the two companies are different. TVM has only one Indian Director while TVI has five of them. There are no common directors. It is therefore, claimed that the management of TVI is entirely independent of that of TVM. It was contended that the effective place of management of the company is in Mauritius. Hence, the applicant is a non-resident under section 6 and is therefore eligible to approach the AAR for an Advance Ruling on transaction/s proposed to be entered into by it.

TVM was engaged, *inter alia*, in the business of development, operation, marketing, sale & distribution of Television Programmes and broadcasting of

Television Channels. TVI was engaged in the production of software programmes to operate the Channels. It had developed a logo for its programmes namely 'Home T.V.'. TVI proposed to licence the software produced by it in its own studios as well as by other producers to TVM. TVI would permit TVM to use its logo 'Home T.V.' in the telecast made by TVM. The software programmes acquired by TVM from TVI as well as other groups like Pearson, Carltons, BBC, etc. was to be broadcast by it through a transponder taken on lease by Carltons and sub leased to TVM. The transponder was linked to an earth station owned by another Hongkong Company. It was attached to Satellite with a broadcasting coverage, which covered 68 countries and in turn, transmitted its signals, which were received by dish antennae located in these countries, which were tuned in to the particular satellites. These signals were then transformed into sound and picture and become available for viewing through television sets in these countries.

TVM earned revenue by way of advertisement from advertisers. TVM desired to sell air time on its channel to parties in India. It therefore proposed to enter into solicitation agreement for such sale with TVI where under TVI would only solicit orders from the purchasers of air time and pass on those orders to TVM for its scrutiny and acceptance. TVI would also be responsible for remitting the advertisement revenue so collected to TVM and be entitled to a commission for the services rendered by it in this regard. TVI had no authority to conclude the contracts. TVM directly enters into contracts with the parties in India.

TVI was entitled to collect from relevant purchasers a commission at a rate mutually agreed between TVI and TVM but not exceeding 10percent of the amount of invoice issued to the purchaser by TVM. TVI and TVM have made it clear that they were entering in to this agreement as independent contractors and that TVI was not the dependent agent of TVM, and that TVM and TVI were not joint venture partners.

The point at issue was, under the above arrangement, whether the profits earned by TVM by sale of air time on the television channel broadcast in, *inter alia* India, would be liable to tax in India?

The following questions were raised before the AAR:

1. Whether the business profits earned by the applicant from sale of air time on the television channel broadcast in, *inter alia*, India, would be liable to tax in India?

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2. Whether the agent appointed by the applicant to solicit orders from the purchasers of air time and to pass on those orders to the applicant for acceptance, could be construed as a PE of the applicant in India?
3. If the answer to question No.2 is in the negative, whether any part of the business profits earned by the applicant could still be deemed to accrue or arise in India and, therefore, liable to tax in India?

The applicant contended that the activities of TVI were of an independent nature and though it has developed the programme for VM and permitted it to use the logo "Home TV" developed by it, was also negotiating with other parties namely Raj TV, Star Plus and Mauritius Broadcasting Corporation similar for arrangement. It was also contended that the canvassing for advertisement was done by TVI in the ordinary course of its business. Therefore the business of TVI was not confined or devoted exclusively or almost exclusively to TVM. TVI should, therefore, be considered to be, an agent of independent status within the meaning of clause (5) of Article 5 of the DTAA.

The AAR observed that the main questions to be considered were, whether the profits of TVM, which was a Mauritius Enterprise, were taxable in India. TVM being a Mauritius Enterprises its profit were prima facie taxable in Mauritius. Under Article 7(1) of the DTAA between India and Mauritius, the business profits of TVM can be taxed in India only if it had PE in India and that also only to the extent its profit are attributable to that establishment. The main issue was whether TVM can be said to have a P.E. in India under Article 5 of the DTAA between India and Mauritius. TVM had no fixed place in India. Even if the presence of TVM was taken for granted; in terms of Para 3(c) of Article 5 the possibility of it being considered as a P.E. was excluded (mere maintenance of stock of goods etc. does not make one a P.E.).

The next question was whether the common shareholding of TVM and TVI can be a good ground to hold that TVI was a P.E. of TVM. The AAR clearly stated that the two were separate legal entities. More over TVM did not exercise control over the activities of TVI. Though the shareholders may be common, directors were not. Though there may be close relationship between the two companies and even the possibility of TVM being able to exercise control over TVI, it may not be enough to constitute TVI as the P.E. of TVM under Para (6) of Article 5. Mere fact that the shareholding groups of TVI and TVM are common does not make TVI P.E. of TVM.

The relationship between TVI and TVM was that TVI was just an agent for the collection of advertisements for TVM to be broadcast on its (TVM) channels. This was governed by para 5 of Article 5. A broker or commission agent of an independent status could not be termed as a P.E. where such person was carrying on his own business and is dealing with the enterprise only as one of his man clients and dealings between the two are on a commercial basis.

In order that an agent can be treated as having an independent status the following two conditions must be fulfilled.

- (a) Such agent must be acting in the ordinary course of his business
- (b) The activities of such agent should not be devoted exclusively or almost exclusively on behalf of that enterprise.

The Authority pointed out that it was difficult to accept the contention of the counsel because clauses (4) and (5) of Article 5 deal with the activities carried on by an enterprise of one contracting state in another state through the medium of an agent. As per the said clauses, the agent will be considered to be of independent status if he carries on the activities on behalf of the non-resident in the ordinary course of its business and if those agency activities are not substantially speaking, confined to a single principal namely the foreign enterprise. One should therefore, examine, firstly whether in carrying on the profit earning activities namely the sale of advertisements and collection of advertisement revenue - TVI is acting in the ordinary course of its business.

The AAR stated that no material was placed by the applicant to enable the Authority to answer this question in the affirmative. In the instant case the only one company was handled by TVI i.e. TVM. Presently TVI has been canvassing only on behalf of TVM. Whatever may be the position at a later date, in the event of TVI expanding the list of broadcasters for its software and extending the scope of its advertisement canvassing; presently, however, the activities of advertisement of TVI are confined only to TVM under the proposed solicitation agreement. However, the AAR observed that Clauses 4 and 5 of Article 5 are interwoven (hence, read together). Para 4 clearly states that if the agent does not have the authority to conclude contract, the entity will not be said to have P.E. in India, under clause 5 of Article 5. Clauses 4 and 5 are to be read together. Clause 5 should not be read in isolation. As per the solicitation agreement, TVI is not the final arbiter

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in the matter of telecast of the advertisements procured by it. It does not have any authority to conclude the contracts. On this reasoning TVI was held to be an independent agent and, hence not P.E. of TVM.

The AAR further observed that para 4 of Article uses two expression "has" and "habitually exercises" an authority to conclude contracts on behalf of the enterprise in question. The expression 'has' may have reference to the legal existence of such authority on the terms of the contract between the principal and agent; the expression 'habitually exercises' had certainly reference to a systematic course of conduct on the part of the agent. If despite the specific provision of the soliciting agreement, it is found, as a matter of fact, that TVI is habitually concluding contracts on behalf of TVM without a protest or dissent, then it could be presumed either that the relevant provisions of the agency contract are a dead letter ignored by the parties or that the principal has agreed implicitly to TVI exercising such powers notwithstanding the terms of the contract. If such a situation is found to exist, then perhaps it could be said that TVI constitutes a P.E. for TVM despite the clauses of the contract relied upon. Solicitation agreement has not been approved or acted upon and, having regard to the identity of the groups of shareholders in both the companies, it is difficult to speculate how the transaction will be finally put through. The department can certainly investigate the actual state of affairs and draw appropriate conclusions. But the mere contention that its identity of shareholders and close business connection with TVM and its representing TVM in its Indian transactions for collection of advertisements and revenue, cannot be held to make TVI a P.E. of TVM.

The AAR also rejected the tax authorities objection that the reference should not be answered as the transaction was prima facie designed to avoid tax after considering the contention of both sides as it came to the conclusion that there were satisfactory commercial considerations for the constitution of TVM as a company in Mauritius. 15.1. Another important objection raised by the tax authorities was in regard to applicant's eligibility to any benefit at all under Article 7 of the Treaty. The objection was on the ground that the provisions of DTAA would be applicable only if the recipient was resident in Mauritius in terms of the DTAA and was liable to pay tax in that country. Under Article 1, the DTAA permits the benefits of the DTAA to flow to "persons" who are resident of one or both of the Contracting States and Article 7 talks merely of an enterprise of a Contracting State, the requirement above mentioned is a must before the applicant can claim the benefit of

Article 7. The reference to tax is the income-tax in Mauritius vide Article 2(1) read with Article 3(d). The Authority requested the applicant to produce the particulars of income tax law in Mauritius. However, the applicant did not produce any, except an averment in a letter by counsel confirming that TVM was liable to tax in Mauritius in respect of its global income. However, the Authority on its own gathered the information and found that in respect of International Business Companies (IBC) they can opt for tax rate from 0 to 35 percent (as off-shore company). TVM being one such company could opt for rate of tax between 0 & 35percent in Mauritius. The Authority stated that if TVM asks for Zero rate of tax, it will become ineligible for relief under the DTAA between India and Mauritius, as it was not liable tax in Mauritius. But if on the other hand it as an off-shore company, which has opted for being subjected to tax and proof of this, is produced, relief under Article will have to be granted. The claim of the applicant will depend on the facts actually prevalent.

Based on the above reasoning the AAR considering the fact that question numbers 1 and 3 were virtually the same and answer to them was dependent on the answer to question number 2. The AAR therefore, pronounced the following common ruling on all the three questions raised.

The business profits were deemed to accrue or arise in India under Section 9 of the Act but were not taxable in India by virtue of the DTAA, if TVM's liability to pay tax in India is established and only TVM and not TVI is shown to exercise generally the power to conclude the advertisements contracts for the sale of air time.

5. AI Nisr Publishing, In re, [1999] 239 ITR 879 (AAR)

The applicant was a firm resident in Dubai in the UAE and was engaged in the business of publishing, printing and distributing newspapers. The applicant sold advertising space to clients for publication in the newspaper "Gulf News". In order to solicit orders for advertisement the applicant entered into agency agreements with advertisement representatives in several countries and in India with Bennett Coleman and Company Limited (BCL) to be appointed as an exclusive agent for solicitation of advertisements. Terms of the agreement *inter alia* provided that BCL would be the exclusive agent for soliciting advertisements from recognized advertising agencies and national advertisers in India for the applicant's publications. BCL to inform all the advertisers that it would not enter into any contract or accept any order

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on behalf of the applicant or act on behalf of the applicant or attempt to bind the applicant in any way and that all orders were subject to acceptance by the applicant. BCL was entitled to 30percent commission to be deducted out of charges collected by it before remittance to the applicant. BCL was free to act as advertising agent in India for other overseas newspapers, magazines and publications.

ISSUES

The applicant filed an application before the AAR requesting the ruling on the following questions

- (a) "Whether, in the facts and circumstances of the case, any business profits or income accrues or arises in India in the hands of the applicant out of advertising revenue received/ receivable from its agent(s) in India?
- (b) Whether such advertising revenues remitted out of India by the agent(s) of the applicant is subject to deduction of tax at source under Section 195 or any other provision of the Act and, if so, what would be the amount on which the tax would be deducted at source?"

The tax authorities contended that the applicant had business connection in India and therefore any income, which accrued or arose to it in India from the advertisements, should be deemed to accrue or arise in India under Section 9(l)(i) of the Act. The tax authorities contended that BCL was not an independent agent.

The applicant on the other hand contended that the agreement between BCL and the applicant was a non-exclusive arrangement and that BCL was at liberty to, and in fact, does act as advertisement agent in India for several newspapers. At the relevant time it was acting as advertisement representative for as many as 19 foreign publications published in different countries in the world. To this effect a certificate was furnished by the BCL. The applicant relied on several other applications filed before the AAR on similar questions where BCL was also acting as advertising agent in India for others. The applicant also proved that in certain cases it was directly dealing with the advertisers and therefore BCL was an independent agent and therefore not a PE of the applicant. Under Article 7 of the Treaty no business of the profits of a non-resident can be brought to tax in the absence of a PE. The dealings of the applicant through BCL cannot be said to constitute "Business Connection" within the meaning of Section 9 of the Act, as the

applicant had no PE in India it is not liable to any tax on the advertisement collections received from India.

The AAR observed that Paragraph 4 is applicable only to a case where a person who acts as agents for the non-resident is not an agent of independent status within the meaning of paragraph 5. BCL was an agent for receiving advertisements and collecting advertisement revenues on behalf of the applicant in India. But the agency was non-exclusive. The Memorandum of Association of BCL permitted it to carry on business as advertising agents and in exercise of this power. BCL had entered into contracts with several foreign newspapers to act as the representative to collect advertisements in India. Though the principal business of the BCL was the publication of newspapers in India, BCL was also carrying on business in the collection of advertisement for foreign newspapers and it is in the course of such business that it has entered into contracts with various foreign newspapers. The applicant and BCL were in no way associated with each other and the terms of the contract between them were at an arm's length. The case clearly fell under the terms of paragraph 5 of Article 5 of the DTAA with UAE and BCL though an agent; was an agent of independent status within the paragraph 5. In view of this question of applicability of Section 9(l)(i) of the Act did not arise for, even if it could be said that there was a business connection under the Act, the applicant was entitled to rely on the DTAA and as under the DTAA there was no PE no income would be taxable in India. The AAR therefore, held that the advertising revenues received in India by the applicant were not taxable in India and thud there was no obligation to deduct tax at source.

6. AAR No.24 of 1996 - [1999] 104 Taxman 377 (AAR)

The two applicants, M/s. B and M/s. H, were companies incorporated and resident in the Netherlands. Since their applications raised similar questions, they were disposed of by the AAR by a common order.

An Indian Public Sector company (PSU) entered into a contract with a Korean Company ("K"), which contemplated designing, engineering, procurement, fabrication, transportation, laying/installation, burial, testing and commissioning, etc. of a Trunk Pipeline Project within the territorial waters of India. K, in turn, entered into sub-contracts with an Indian Company M/s. B in respect of some of the items of work to be performed by K under the main contract. The Indian Company, in turn, entered into a sub-contract with M/s.

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H. Thus, B and H, the two applicants were sub-contractors executing portions of the work originally entrusted by the Indian PSU to a Korean company.

H's responsibilities were primarily in the nature of a works contractor performing various physical activities on and in relation to the pipeline constructed for extraction etc. of mineral oil from oil fields located offshore India. B's responsibility was to mobilize from abroad a vessel equipped with a diving plant and other necessary equipment to undertake remedial construction works at the laterals (a lateral being an offset to the main pipeline and equipped with valves to be used later, if required, to connect a new pipeline in the future).

The project undertaken by H was completed within a period of 68 days from 22 February .1995 and 2.May1995 and that undertaken by B was completed within 27 days from 15 December.1995 and 10January 1996.

The following questions were raised before the AAR:

The applicants sought advance ruling of the AAR on the following questions (suitably rephrased).

(i) In H's case:

"In the light of relevant facts as mentioned in Annexure 2 and the applicant's interpretation of law and facts as mentioned in Annexure 3, whether income derived by H from its contract dated 22 February 1995 with the Indian company is taxable in India?"

(ii) In B's Case:

"The taxability [in terms of Article 5 of the Agreement for Avoidance of Double Taxation concluded between India and Netherlands] of revenues earned by B a tax resident of Netherlands, from the contract with the Korean company?"

The applicants submitted that though the income under the said Contracts can be said to arise in India as they arise from activities carried out in Indian territory, they cannot be taxed in India in the absence of a PE. The applicant submitted that the contracts are being carried out by them as part of their regular business activities and the income derived from these activities was in the nature of Business Income. Article 7 of the DTAA regulated the taxability of income from business carried on by a resident of one of the

States in the other State. The applicant therefore stated that the provisions of the DTAA being more favourable would override the provisions of the Act. In this connection the applicants placed reliance on a *Circular No.333, dated 2nd April 1982* of the Central Board of Direct Taxes and the decision of the Andhra Pradesh High Court in the case of *CIT v. Visakhapatnam Port Trust, [1983] 144 ITR 146/15 Taxman 72*.

The AAR observed that the expression 'permanent' was used only in contradistinction to something fleeting, transitory, temporary or casual. The context in which the expression was used amply makes this clear. The language of paragraph (2) [in particular of clause (i)] and that paragraph (3) of Article 5 also indicated that the duration of the establishment need not be for years and may be of months, only the words 'permanent' and 'establishment', when read with the language of paragraph (1) of Article 5, connote the existence of a substantial element of an enduring or permanent nature which can be attributed to a fixed place of business in that country but the issue whether the nexus can be said to be 'substantial' or 'enduring' would depend entirely on the facts and the circumstances of each case. The term 'a place of business' covered both premises and other tangible assets used by the enterprise. In the present case, the diving vessels were fully equipped with all the equipment necessary to execute the contracts satisfy the definition. The AAR also considered the question whether the ship or vessel will cease to be a fixed place of business if in the course of execution of the contract it may move from place to place on the ocean and expressed the view that the expression 'fixed place' envisages the possibility of locating identifying or pointing out to a definite place as the place from which a business carried on and does not import a requirement that the place of business should be stationary and not moving. The diving offshore vessel located and functioning within a defined area can well be described as a fixed place of business from which the applicants are carrying out their business transactions. The AAR then considered Article 5(3) of US Model, OECD Model and UN Model and thereupon observed that a 'construction, installation or assembly project' cannot be treated as a permanent establishment unless it continues for a period of more than 6 months even though it might otherwise fulfill the definition contained in paragraphs (1) and (2) and held that as neither of the contracts under consideration, not even both of them put together, exceed that period in duration, the applicant cannot be said to have a PE in India. The AAR accordingly held that the applicants are not taxable in India on the income earned by them under the sub-contracts under consideration.

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7. AAR P.NO.8 of 1995 [1997] 223 ITR 416 (AAR)

The applicant (ABC) was a non-resident company incorporated in Switzerland. It proposed to set up a subsidiary company in India to provide consultancy services from India to the applicant company for use outside India. The applicant company was a trader in goods and commodities on international basis and intended to trade with India. The Applicant filed four proposed agreements, which were to be entered into with its subsidiary, broadly giving nature of services and the scope of work envisaged by the subsidiary in India for the applicant. The said agreements for services to be rendered were:

- (a) The consultant (i.e. the subsidiary) would provide ABC (i.e. the applicant holding company) with secretarial and clerical assistance to complete documentation of tenders, contracts and subsequent documentation required to enable the Indian customers who had purchased commodities from the Swiss company overseas, to obtain delivery of the said commodity on its arrival in India.
- (b) The consultant would assist ABC in responding to global tenders floated by Indian organizations which entailed providing information and submitting tenders within the parameters laid down by the ABC.
- (c) The consultant would follow-up with the global tenders, do liaisoning with local parties on behalf of ABC and finally, under authority from ABC, sign the formal contract on its behalf in India on the terms and conditions as accepted by ABC.
- (d) The consultant would assist in responding to tenders, follow-up of such tenders, signing of contracts on its behalf and rendering of secretarial services in relation to these activities.

The applicant would retain the Indian subsidiary as consultant on a non-exclusive basis for a year, to be automatically renewed, and the Indian subsidiary was at all times to act on instructions from the applicant and would not have any independent authority to accept orders on behalf of or bind the applicant.

The following questions were raised before the A.A.R.

1. Whether the transactions detailed gave rise to a business connection in India entailing tax liability on the applicant in India on the deemed income accruing or arising in India within the meaning of Section 9(1)(i) of the Act?

2. What would be the extent to which income would be deemed to accrue or arise in India and the extent of taxability of such income?

The AAR held that the scope of business connection as explained by the Supreme Court in the case of *CIT v. R.D. Aggarwal and Co. [1965] 56 ITR 20*, means something more than business. It presupposes an element of continuity between the business of the non-resident and the activity in the taxable territory, rather than a stray or isolated transaction. The AAR observed that the business activity or the business relationship between the applicant and the subsidiary would not be based on any stray transaction but would be a continuous process in respect of the series of purchase and sale transactions undertaken by the applicant in India and in all such transactions the subsidiary would do the work as stated in the four agreements. Such an intimate and continuous relationship will constitute “business connection” for the purposes of Section 9(l)(i) of the Act.

The AAR further observed that the nature of activities of subsidiary was covered by Article 5.2(1) of the India - Switzerland DTAA. Since the activities were proposed to be carried on for a period exceeding 90 days the subsidiary company would be a PE of the applicant in India.

As per Article 5.4 and 5.5 of the said DTAA a person was not regarded as PE if he was established to be an independent agent of the enterprise of the other state. However, in the given case it is difficult to establish this vis-a-vis the subsidiary of the applicant, unless the subsidiary has significant independent activities on its own or on behalf of persons other than the applicant and unconnected therewith.

In view of intimate and continuous relationship between the holding company and its subsidiary, the AAR held that there was a business connection for the purpose of Section 9(l)(i) of the Act. In addition, the activities of the subsidiary amounted to a PE of the applicant under Article 5.2(1) read with Article 5.5 and 5.6 of India-Switzerland DTAA, considered along with four proposed agreements between the applicant and the subsidiary. However, the extent of the income deemed to accrue or arise in India would depend on the actual working of the applicant and the subsidiary. Thus, the question related to the quantification of income was not answered in a hypothetical manner.

8. Airports Authority of India, In re [2005] 273 ITR 437 (AAR)

The applicant, a public sector undertaking, had entered into contracts with a

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US company, RC in 1993 for modernisation of Air Traffic Services in India (i.e. at Delhi and Mumbai). Under these contracts, RC supplied and installed equipment, together with spares, training, documentation, software etc. After a few years, the applicants entered into two separate contracts with RC in 2003 for the repair of equipment (hardware) and for software maintenance support (i.e. repair of software).

In the case of repair of hardware, the applicant would have to fill in a certain prescribed form and send it along with the failed parts to the RC's facilities outside India. RC would then repair the failed part or provide a compatible replacement from outside India and send it back to the applicant in India.

In the case of software maintenance support, on detecting any fault, the applicant would have to fill a prescribed form and send it to RC with crash data and system sub-data to RC's facilities outside India. If it would be noticed that change in the software was required then the system Trouble Report (STR) would be generated and accordingly changes would be made in various modules (each such change is referred to as STR fix). Various STR fixes would be combined to form a software build which, after due verification, would be sent to India along with a version description document, an executive software DAT Tape and a source Code DAT Tape. RC's software engineers would visit India for a total period of 10 days for verification of the fixes/software build. After testing the same on a simulator and downloading it on to the operational system, it would be monitored for 48 hours.

RC did not have a PE in India. All activities in connection with the performance of the contracts would be carried outside India. However, in respect of repair of software, RC's software engineers would visit India for some days for installation and testing of the software.

The applicant sought a ruling from the AAR on the following questions:

- (i) whether the deputation of RC's software engineers to India would constitute RC's PE in India, and
- (ii) whether the payments to RC for repair of hardware and software support maintenance would be taxable in India as business profits or fees for included services under the DTAA.

The AAR held that based on the supply contract entered in 1993; there was outright sale of the hardware to the applicant. The AAR gave its ruling noting the following pertinent aspects of the supply contract of 1993:

- (a) The property in the hardware passed to the applicant when the hardware was dispatched for delivery.
- (b) Thereafter RC was in possession/custody of the same for transportation to site, its installation and site acceptance testing, for or on behalf of the applicant, and was not allowed to deal with it for any purposes except for the contract.
- (c) The applicant paid the customs duty for the hardware.

The AAR also held based on the supply contract entered in 1993, that the computer software and technical documentation required to operate the hardware granted a right to use the same to the applicant subject to certain conditions. The AAR gave its ruling noting the following pertinent aspects of the supply contract of 1993:

- (a) A licence was granted to the applicant to use the computer software and technical documentation on the Air Traffic Control System (ATS).
- (b) The licence indicated that computer software and technical documentation were not the property¹ of the applicant; they were to be used or copied only for the purpose of operating the article or thing in which they were contained.
- (c) There was a stipulation whereby the applicant agreed that the technical data was to be used, reproduced, adopted or otherwise modified only for its ATS in India (i.e. at Delhi and Mumbai).
- (d) The applicant would have to enter into the licence agreement with RC or other relevant proprietors of the computer software and technical documentation for right to use at other locations (apart from Delhi and Mumbai) of the applicant.

The AAR therefore ruled that payment for repair of hardware was business profits of RC, and was thus not taxable in India, as RC did not have a PE in India. The deputation of RC's software engineers to India for installation and testing of the repaired software would not constitute RC's PE in India.

The AAR observed that the payment for initial acquisition of software was 'royalty'. The payment for repair of software would be fees for included

¹ They were the property of the Queen of Canada.

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services under Article 12(4)(a) of the DTAA as payment was for services which were ancillary and subsidiary to the application or enjoyment of the right, property or information for which a royalty payment was received. The AAR thus ruled that payment for repair of software was taxable as fees for included services.

9. Sutron Corporation, In re - [2004] 268 ITR 156 (AAR)

The applicant, a foreign company incorporated in USA was awarded two contracts for the installation of remote stations by the Government of Andhra Pradesh (GOAP). The applicant prepared and signed the proposal for the contracts in USA, however the same were entered into with GOAP in India through its authorized Country Manager (CM) in India. The first part related to supply and erection of equipments purchased outside India, which was delivered in USA to the carrier, appointed for and on behalf of the GOAP. The second part related to provision of local materials/services for which it entered into a Memorandum of Understanding (MOU) with an Indian company who would provide the desired local materials/services and would recover its cost from the applicant. The consideration for the first part was payable by GOAP in USD in USA and the consideration for the second part was payable in INR in India.

The applicant sought a ruling on the following questions:

- (i) Whether any income/profits accrued/arose or could be deemed to accrue/arise in India in respect of the above transactions and
- (ii) Further based on the DTAA between India and USA could the applicant be said to have a PE in India.

The AAR held that the profit accrued/arose in India and as applicant had a permanent establishment in India, as per the DTAA the profits to the extent attributable to the PE would be taxable in India. The AAR held the CM to be a paid dependent agent of the applicant who concluded contracts in India on behalf of the applicant. The AAR also treated the residence of CM as a fixed business place in India of the applicant, which could be termed as place of management or an office. The AAR therefore held that the company has a PE and the profits of the company would be taxable in India to the extent attributable to the PE.

The AAR also observed that the Indian portion of the contracts being carried out by the Indian company had no relevance since as; per the contract with

GOAP the applicant alone was entitled to receive and had received all consideration under the contract and the receipt of consideration by the Indian concern was due to an internal arrangement between them.

Thus, the profit of the applicant was deemed to accrue or arise in India and to the extent attributable to the permanent establishment was liable to be taxed in India.

10. AAR No. 606 of 2002 CIT v. Danfoss Industries Private Limited [2004] 268 ITR 1 (AAR)

The applicant, Danfoss Industries Private Limited, an Indian company and a member of the Danfoss Group of companies, proposed to enter into an agreement with Danfoss Industries Private Limited, Singapore, a group company incorporated in Singapore (Danfoss Singapore), for availing various services like advice and assistance on conduct of market research, surveys and strategies, advertising campaigns, advice and assistance on financial matters, assistance regarding seminars, customer training, employee relations and review, analysis and recommendations on improvement of management and business activities. Such services were provided by Danfoss Singapore to various Danfoss Group companies, in order to enable them to carry out operations in an economic and efficient manner and to maintain global standards set by Danfoss Group.

The agreement provided for payment of service fees by a member based on the portion of services received by it in relation to the total costs incurred by Danfoss Singapore in providing such services. The fee for each individual company would be calculated on the basis of an allocation key based on proportional percentage of budget turnover weighted by growth rate and market maturity. The weighting would be subject to modifications on the basis of previous year's results, at the request of either party to the agreement or at the request of any remaining Danfoss company at any time in case a Danfoss company departs from the broader arrangement.

The applicant applied to the AAR seeking an advance ruling as to whether the payments made by it to Danfoss Singapore for services obtained by it would be subject to tax withholding under Section 195 of the Act. It contended that the payments that it proposed to make would be only in the nature of reimbursement of actual expenditure incurred by Danfoss Singapore and there would be no income element embedded in these payments.

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The jurisdictional (CIT) contended that the amount proposed to be paid would be in the nature of income and not reimbursement of cost taking into account the terminology used in the agreement. He argued that the payment to Danfoss Singapore was service fees based on actual cost but it was not reimbursement of actual cost. He added that if it were only reimbursement of the actual cost, it would have been simply mentioned in the service agreement that the actual cost of service would be paid by the company.

The applicant contended that the amount proposed to be paid would be reimbursement of cost incurred by Danfoss Singapore as it had no element of income in the 'service fee' payable by it. The applicant relied upon the decision of the Calcutta High Court in the case of *CIT v Dunlop Rubber Co. Ltd* [1983] 142 ITR 493 where the High Court held that payments made for reimbursement of share of research expenses were not in the nature of royalties and that the research expenses benefited the group as a whole. The applicant also relied upon the decision of the AAR in *DECTA v CIT* [1999] 237 ITR 190.

The CIT referred to the agreement between the applicant and Danfoss Singapore and contended that there was no nexus between the actual costs incurred by Danfoss Singapore in providing the said services and the fees payable by each individual service availing company. He contended that an element of profit is not an essential ingredient of a receipt to be taxable as an income. In the absence of breakup of expenses incurred by Danfoss Singapore in providing services and fees payable by each individual company he argued that such service fee paid by companies would not be in the nature of reimbursements.

The AAR, after looking into the agreement and other submissions made by the applicant, held that there was no direct nexus between the actual costs incurred by Danfoss Singapore in providing the said services to a Danfoss group Company and the fees payable by each individual company, which would have availed of the services. The AAR held that in the absence of the breakup of the cost incurred by Danfoss Singapore in providing such services and fees payable by each individual company, the amount payable by Danfoss India could not be treated as reimbursement of expenses. The AAR was also influenced by the fact that the Agreement clearly referred to "consideration" for providing services.

The AAR held that even if fees charged are assumed to be equivalent to the

expenses incurred by Danfoss Singapore in providing the services and even if there would be no profit element, it would be still regarded as service fees and not reimbursement of expenses, and the same would therefore have income embedded in them. Thus the payments by the applicant would have to be made after withholding tax under section 195 of the Act.

The AAR relied upon the decision of the Supreme Court in *Transmission Corporation of A.P.Ltd. & Another v CIT [1999] (239 ITR 587) (SC)* wherein the Supreme Court held that the expression “any other sum chargeable under the provisions of this Act” would not only include amounts with income bearing characteristics such as salaries, dividend etc. but also gross sums, the whole of which might not be income or profit of the recipient, such as payments to contractors, payment of insurance commission etc.

11. Timken USA India Limited, In re – [2005] 273 ITR 67 (AAR)

The applicant, an Indian company, was engaged in the business, *inter alia*, of manufacture and sale of bearings and other ancillary products. The applicant was a subsidiary of a US company (Timken USA). The applicant entered into an agreement on 2 August 2000 with Timken USA whereby Timken USA rendered various services to the applicant in the USA.

The services rendered included management services, system development and computer usage, communication services, engineering services, process in tool design services, manufacturing services etc. The compensation payable by the applicant to Timken USA for services received would cover only the cost actually incurred by Timken USA and no profit element or mark-up on cost would be added to it.

The applicant approached the AO for an order under Section 195 of the Act, authorising it to remit the above payment without deducting any tax, on the ground that the payment was only reimbursement of expenditure/cost actually incurred, not having any mark-up or profit element and so no tax was deductible there from.

The AO passed an order under Section 195 of the Act declining to examine whether the payment had an element of profit embedded in it, as the same would be a subject matter of an enquiry in the course of a regular assessment of Timken USA. The AO held the payment as FTS liable to tax on gross basis². The applicant preferred an appeal to the CIT (A) but later withdrew the appeals and approached the AAR for its ruling.

² Sections 9 (1)(vii) and 44D of the Act read with section 115A of the Act

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The applicant sought a ruling from the AAR on the following:

- (a) Whether the payment made to Timken USA represented recovery/reimbursement of the expenditure/cost actually incurred and so the same would not be taxable in India.
- (b) If the payment to Timken USA would be treated as fees for technical, then the same would be taxable on net basis (i.e. granting relief under Sections 28 to 44C of the Act) based on the principles³ laid down in decision of the Supreme Court in the case of *Union of India v A. Sanyasi Rao and others* [1996] 219 ITR 330 and so the payment to Timken USA would not be taxable, as it did not contain any element of profit or income in it.

The AAR observed that in *Danfoss Industries Pvt Ltd, In re -* [2004] 268 ITR 1 it had taken a position that an element of profit was not an essential ingredient for a receipt to be taxable as income and even assuming that the fees charged were equivalent to the expenses incurred in providing services and there was no profit element, it would still be a case of quid pro quo for the services received by the applicant and not a case of reimbursement of expenses.

The AAR observed that the principle laid down by the Supreme Court in the case of *A. Sanyasi Rao and others (supra)* in interpreting Section 44AC of the Act could not be called in aid in interpreting Section 44D of the Act because the Supreme Court had also observed that Section 44D of the Act among other sections related to a non-resident carrying on business in India and its provisions were not much relevant in construing Sections 44AC and 206C of the Act.

The AAR observed that the Supreme Court has not laid down a principle that in every provision dealing with presumptive taxation, where relief under Sections 28 to 43C of the Act was denied, an option could be read to avail of the relief under Sections 28 to 43C of the Act. The AAR observed that in Section 44AC of the Act, within the same category of the taxpayers viz domestic taxpayers, different treatment was meted out to different traders in

³ Taxpayers liable to pay tax on presumptive basis under sections 44AC of the Act could not be denied the relief for expenditures/allowances provided under sections 28 to 43C of the Act.

regard to allowability of expenses while computing the income whereas in Section 44D of the Act all the foreign companies are treated alike.

The AAR observed that Section 115A of the Act *inter alia* also mandated that no deduction of any expenditure/allowance under Sections 28 to 44C of the Act and Section 57 of the Act should be allowed to the taxpayers in computing their income by way of royalty or FTS.

The AAR held the payment made to Timken USA did not represent recovery/reimbursement of expenditure/cost actually incurred. The same was liable to tax as FTS on gross basis under the Act and the DTAA between India and USA.

12. Morgan Stanley & Co International Limited, In re – [2005] 193 CTR 161/ 142 Taxman 630 (AAR)

The applicant, a foreign company, was a tax resident of UK and was registered with the Securities and Exchange Board of India (SEBI) as a Foreign Institutional Investor (FII). It invested in the Indian stock market and offered income thereof as capital gains. It proposed to expand its business in derivative trading operations in India. For which, it obtained permission from the RBI and would also avail services from brokers, custodians and bankers.

According to the applicant the income from trading in derivatives was business income and not capital gains. The same was not taxable in India in the absence of a PE.

According to the tax authorities the dealing in shares and share based exchange traded derivatives was inter-linked, the income from shares was taxable as capital gains so the income from trading in derivatives should also be treated as capital gains. Further, even if the income from trading in derivatives was treated as business income, the same was taxable in India as the applicant had a PE in India.

They relied on the decision of the Mumbai Bench of the Tribunal in the case of *DHL Operations B. V. Netherlands I T A Nos 7987 and 7988/Bom/92 dated 3rd October 2000 [Unreported]* and observed that the difference between a dependent agent and an independent agent has to be seen from the perspective of the principal and not from that of the agent.

The applicant sought a ruling from the AAR whether the income derived by it from trading in derivatives in India was taxable in India under the DTAA between India and UK.

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The AAR held that the income of the applicant from trading in derivatives in India was business income, not taxable in India in the absence of a PE in India.

The AAR observed that it would be necessary to consider whether the income of the applicant from trading in derivatives was a revenue receipt or a capital receipt.

The AAR observed that the derivatives had a short life span of three months, they would be short-term capital assets but if they were held as stock in trade then the income arising from transactions of their purchases and sales could not be termed as capital gains. If they were held as investments then the income arising from such transactions would be capital gains and taxable even in the absence of a PE in India.

Based on the features of the derivatives the AAR observed that investment in derivatives with a view to derive income was not possible. The income could be derived only on the purchases and sales of the derivatives so they were held as stock-in-trade and hence excluded from the definition of capital assets⁴.

The AAR perused the final details of derivatives traded between 1 April, 2003 and 31 March, 2004, which indicated the substantial nature of transactions, the magnitude of purchase and sales was enormous⁵ and the ration of purchases and sales was very high. It also observed that derivatives being stock in trade were excluded from the definition of capital asset.

The AAR thus held that the income from trading in derivatives was business income covered under Article 7 of the DTAA.

The AAR noted that the business income of the applicant would be taxable in India only if the applicant had a PE in India.

The AAR relied on the Article 5 of the DTAA and observed that there was no merit in the contention of the tax authorities that the difference between a dependent agent and an independent agent has to be seen from the perspective of the principal and not from that of the agent.

The AAR relied on the Article 5(5) of the DTAA and observed that an enterprise would not be deemed to have a PE in India if it carried on

⁴ Under Section 2 (14)

⁵ INR 3932 crores in a year

business in India through an agent of independent status acting in the ordinary course of its business and the activities of such an agent were not wholly or almost wholly devoted for the enterprise.

The AAR observed that for the purpose of Article 5(5) of the DTAA the enquiry required to be made was whether the entire activities relating to the non-resident were carried on wholly or almost wholly by the agent on behalf of the non-resident enterprise and not whether the agent was carrying on various activities other than being an agent of the non-resident.

The AAR noted based on the above observation that in the case of *DHL Operations B. V. Netherlands*, the test applied by the Tribunal for application of Article 5 was not a correct one.

The AAR rejected the contention of the tax authorities that the brokers dealing with the applicant would allot the work of the applicant to its employee(s) having separate enclosure and dealing wholly or almost wholly with the work of the applicant so the employee(s) would be the PE of the applicant because Article 5 dealt with brokers agent etc and not their employees. Further, it observed that there was nothing on record suggesting that the employee(s) did only the work of the applicant and even so it was an internal arrangement of the brokers and their employee(s).

The AAR relied on the agreements entered by the applicant with brokers, bankers and custodians and observed that they were acting in their ordinary course of business, providing services to various clients including the applicant and their activities were not devoted wholly or almost wholly on behalf of the applicant so they could not be regarded as the PE of the applicant under Article 5 of the DTAA.

The AAR thus held that the income of the applicant from trading in derivatives in India was business income not taxable in India in the absence of a PE.

13. Dun & Bradstreet, In re [2005] 193 CTR 9 (AAR)

The applicant, a Spanish company, was an associate of the Dun & Bradstreet group (DB group). It was a subsidiary of an American company (DBUS). DBI, an Indian company was a subsidiary of another foreign company belonging to the DB group.

The DB group provided various products to various businesses worldwide, one of them, being a Business Information Report (BIR), which was provided

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electronically through the master server of DBUS. A BIR provided information on various aspects of a company viz its existence, operations, financial condition, management's experience, line of business, facilities and location of the prospect and also information about any suits, liens, judgements etc.

The modus operandi of the business of DBI was that whenever a customer placed an order for the BIR of a Company situated in Spain, DBI would access the master server of DBUS. The master server on identifying DBI would allow access to connect to the mirror server of the applicant situated in DB group's server farm in the USA. DBI would then request for the required BIR and on being located, DBI would download, print and deliver a copy thereof to its customer.

DBI was under an obligation not to take additional copies or reproduce the BIR in any manner or sell it to any customer other than Indian customer on whose requisition the BIR was ordered. This was so because the BIR was copyright protected with the copyright vested in the applicant, as it had prepared the BIR. The Indian customer was under an obligation to use the BIR for its own purpose. The copyright in the BIR was neither licensed nor assigned either to DBI or the Indian customer.

DBI was free to determine its price for the BIR on principal to principal basis to be charged from the Indian customer. The applicant would not have any say in fixing the said price. The applicant charged the average domestic price at which it sold the BIR to local customers in Spain for the BIR sold by it to DBI. The applicant did not have any subsidiary, branch, office or place of business in India. It also did not have any employee, advisor or agent in India or have any employee deputed to India.

The applicant sought a ruling from the AAR whether the payment made by DBI to the applicant for electronic purchase of the BIR would form part of the business profits of the applicant and would be taxable in India holding that the applicant had a Permanent Establishment in India.

The Director of Income-tax (International Taxation) (DIT) in his comments to the AAR stated that DBI would constitute a PE of the applicant in India and the payment made by DBI to the applicant for electronic purchase of the BIR would be taxable as business profits. The DIT contended the following:

- (a) DBI was a branch/sales outlet/dependent agent of the applicant.
- (b) DBI had a password protected access to the applicant's website to

access the BIRs of the applicant which amounted to DBI habitually maintaining stock of goods/merchandise on behalf of the applicant. Further, the applicant received payment and allowed access of the BIRs to DBI, which amounted to delegation of sales function by the applicant to DBI.

Further the DIT stated that as the BIR was copyright protected, the end user could use it only for its own purpose and the analysis of raw data in the BIR would be similar to technical/consultancy services. The payment could be taxable as royalty/fees for technical services.

The AAR held that the payment made by DBI to the applicant for the electronic purchase of the BIR would be the business income of the applicant but the same was not taxable in India, as the applicant did not any PE in India.

As regards the DIT's contention that DBI could be regarded as a branch/sales outlet of the applicant, the AAR observed that the branch/sales outlet were the projections of an entity depicting management and control of the entity over them. DBI was a separate legal entity and there was nothing on record, which showed that it was a part of or under the control or management of the applicant. The AAR further observed that it was a usual feature of some foreign groups of companies that they were well connected with a view to control the worldwide business or minimize tax liability as a measure of tax planning.

As regards the DIT's contention that DBI habitually maintained stock of goods/merchandise on behalf of the applicant and there was delegation of sales function by the applicant to DBI, the AAR observed that DBI accessed the applicant's server to entertain a customer for a BIR. The applicant granted access to its server to DBI only after knowing the particulars of BIR required by DBI for its customer.

The AAR held that the transaction was more akin to sale by the applicant to DBI rather than delegation of sale function to DBI. The applicant permitted DBI to take a BIR from the stock maintained by it and not that DBI maintained stock of the BIRs.

As regards the DIT's contention that DBI was an agent of the applicant, the AAR observed that an agent was one who worked for another in accordance with his authority while dealing with third parties. It observed that IDBI, being an independent entity carried on its business without any control/instructions

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of the applicant. The pricing of the BIR between DBI and its customer and between the applicant and DBI were independent. It also could not be said that DBI wholly devoted itself to the applicant. The AAR held that DBI could not be treated as an agent of the applicant.

As regards taxability of the payment by DBI as royalty/fees for technical services, the AAR held that BIR was a standardized product of the DB group. The information in BIR was publicly available, which were collected/complied by the associates of the DB group.

The AAR observed that the applicant did not have any server in India for DBI. The database of the applicant was available to the public at large with regular Internet access at a price as in case of buying a book. No specific hardware/software was required and also there was not a pre-requisite that the BIR must be downloaded by DBI only.

The AAR held that the transaction of sale BIR did not involve any transfer of intellectual property nor could it be regarded as technical/ consultancy services, therefore, the payment could not be treated as royalty/FTS.

The AAR, thus, held that the applicant did not have a PE in India so the payment by DBI to the applicant for electronic purchase of BIR was not taxable in India as the business profits of the applicant nor was it taxable as royalty/FTS.

14. UPS Jetair Express Pvt. Ltd [2005] 274 ITR 501 (AAR)

The applicant was an Indian company, a 60:40 joint venture of an American company and another Indian company, respectively. Another American company (UWF), which alongwith the applicant, the co-venturer American company and some other companies were members of UPS group of companies engaged in the business of international integrated transportation services using the 'UPS' logo/trademark.

The applicant entered into the International Transportation Services Agreement (the agreement) with UWF on 30 October, 2000 in respect of international transportation services for the movement of packages within and outside India. The relevant terms have been referred later.

Under the agreement: (a) the applicant provided services to UWF for transportation of packages in India (inbound consignments) and received payment for it from UWF; (b) UWF provided services to the applicant for transportation of packages throughout the world (outbound consignments) and the applicant made payment to UWF for it.

The applicant (for outbound consignments) and UWF (for inbound consignments) picked up the packages, raised invoices on its customers and rendered the packages to international airlines/on board courier for transportation/delivery. Thereafter, UWF and the applicant delivered the packages to the consignees. The applicant and UWF were responsible to their respective customers for transportation of packages and for risk pertaining to the loss and damage to the consignments. UWF did not own or otherwise operated through any business premises in India.

The applicant has sought a ruling from the AAR whether the income arising to UWF from international transportation services rendered under the agreement was taxable in India under the Act or the DTAA between India and USA.

Based on the above facts, the tax authorities had in its comments sent to the AAR concluded that since UWF was not carrying out any operations in India, no income of it could be deemed to accrue or arise in India, hence, was not taxable in India. However, the Dy. Director of Income-tax (International Taxation) in an order passed under Section 197 of the Act held that the income derived by UWF from international transportation services rendered to the applicant under the agreement was taxable in India and that the applicant was required to deduct tax at the rate specified in the order on the net sum payable to UWF. Thereafter, the tax authorities in their further comments contended that the applicant was an agent of UWF to carry out UWF's business operations in India, the applicant worked directly under the control and supervision of the UPS group and UWF borne the loss/damage, therefore UWF had business activity in India.

The AAR held that the income arising to UWF from international transportation services rendered by UWF to it under the agreement was taxable in India.

The AAR observed that to determine the issue, it was necessary to find out whether, under the agreement, the applicant was acting as a dependent agent of UWF or was acting as an independent contractor doing its own business and it analysed the terms of the agreement.

The AAR observed that the following aspects could not make the applicant a dependent agent of UWF.

- (a) The applicant followed the prescribed manuals/guide and procedure (calculating dimensional weight of the packages which would be

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subjected to audit) of UPS to adhere to the standard procedure etc for international transportation business of UPS group.

- (b) There were checks and balances within the UPS group of companies and so each company in UPS group (including the applicant) was working as a well-knit group one catering to the need of the other each being entitled to use UPS brand name.

The AAR referred to the decision of the Supreme Court in the case of *Lakshminarayan Ram Gopal and son v Government of Hyderabad [1954] 25 ITR 494* to note the distinction between the contractor and the agent. It observed that the contractor is independent of any control or interference and is only bound to produce the specified result as per the contract whereas the agent is required to exercise his authority in accordance with the lawful instructions given to him by his principal but not under the direct control or supervision of the principal.

The AAR noted that in the agreement the applicant was referred to as an independent contractor and it was specifically provided that the terms of the agreement should not be deemed to constitute a partnership relationship between the parties and that one party had any authority to bind or to contract in the name of another.

The AAR noted and analysed the terms relating to payments for services, in particular nature and extent of compensation/revenue sharing; right to audit dimensional weight of packages, risk factors, insurance etc.

The AAR noted some peculiarities about compensation and observed that in the agreement the Exhibit B captioned as "Compensation and Revenue Transfer" setting forth the compensation structure provided that UWF would pay to the applicant compensation for its services for each shipment upon presentation to UWF proof of delivery. In case of outbound consignments the applicant was entitled to only a small percentage of the amount collected by it and the balance amount went to UWF by way of transfer of revenue based on specified percentage and that is why the caption for Exhibit B included 'Revenue Transfer' and in case of inbound consignment only specified amount was paid to the applicant and the balance remained with UWF.

Further the AAR observed that the import of the word compensation for services used in the agreement included not only charges for the services of the applicant but also included charges for the employees, equipment, and insurance charges of the applicant. The compensation for services was also

paid in respect of outbound consignments by UWF where in fact it should have received compensation from the applicant.

The AAR noted that UWF had right to audit the shipment of dimensional weight of packages and also the internal accounts and operating records of the applicant. Further, UWF had undertaken all the risk to the shipment insured by the applicant by including its name as insured.

The AAR held that all these aspects militated against the applicant being an independent contractor in performance of services for UWF. It held that the applicant and UWF were inter-connected in their business operations and under the agreement the applicant had assumed the role of such an agent that it purported to act on its own behalf but in fact its activities conferred the benefit on UWF.

The AAR held that the business activities carried on by the applicant in India were not of its own but were for and on behalf of UWF and therefore it could be said that UWF had business operations in India under Section 9(1)(i) of the the Act and its income from international transportation services rendered under the agreement limited to the business operation carried out by the applicant was taxable in India. As regards the applicant relying on *CIT (Inv) v M/S Elbee Services Ltd dated 26 May 1999* and contending that prior to the agreement, UWF had an agreement with Elbee Services on similar facts and the Mumbai Bench of the Tribunal had held that no income would be deemed to accrue or arise to UWF in India and the High Court had dismissed the application for reference of question of law, the AAR held that the Elbee's case did not apply to the applicant because in the case of *Elbee (supra)*, no part of the operation of UWF attributable to the dispatch of consignment out of India was carried out by UWF in India and the case related to remittance made by Elbee to UWF for the services rendered by UWF in connection with consignment sent by Elbee to international destination.

The AAR relied on Article 5 of the DTAA between India and USA and observed that as the applicant was an agent acting for and on behalf of UWF it would have to be regarded as the PE of UWF.

Based on the agreement, the AAR concluded that in case of outbound consignments booking orders, collecting packages etc and in case of inbound consignments in regard to clearance/delivery of packages the applicant was acting for UWF and therefore Article 5(4) applied to UWF and the applicant constituted PE of UWF in India.

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The AAR thus, held that the income arising to UWF from the transaction of international transportation services entered into with the applicant under the agreement was taxable under the Act and the DTAA.

15. UAE Exchange Centre LLC before AAR, [2004] 189 CTR 467 (AAR)

The applicant was a Limited Liability Company (LLC), incorporated in United Arab Emirates (UAE) engaged in the business *inter alia* of remittance services for transferring amounts from UAE to various places in India. The Company was licensed by RBI to set up Liaison Offices (LOs) in India to undertake certain activities. The LOs were carrying on activity strictly in terms of the conditions specified by the RBI.

The applicant sought a ruling on whether any income accrued/arose or could be deemed to accrue or arise in India on account of the activities carried out by it in India.

The AAR held that based on the activities carried out by the LOs, there was real and continuous relation between the businesses carried on by the company in UAE and the LOs in India, and the LOs directly or indirectly contributed to the earning of the income by the company. Therefore, income was deemed to accrue or arise to the company in UAE from the 'business connection' in India and so much of the income as was reasonably attributable to the operations which are carried out in India is taxable in India as per domestic tax law.

The AAR observed that if the activities of the LOs are preparatory or auxiliary in nature, the LOs would not be a permanent establishment in India within the meaning of the term as defined under Article 5 of the DTAA between India and UAE. However, those activities, which are essential activities in the performance of contractual obligations of the UAE establishment, cannot be said to be auxiliary activities but these are a significant part of the main work of the UAE establishment. In such a case, there is a permanent establishment in India of the UAE Company. The AAR ruled that so much of the profits as are attributable to the UAE company's permanent establishments in India are taxable in India under the DTAA.

However, this ruling was quashed by the Delhi High Court in the case of **U.A.E Exchange Centre Ltd. vs. Union of India (2009) 313 ITR 94 (Delhi)** and the High Court held that the activity carried on by the liaison offices in India did not, in any manner, whatsoever, contribute directly or indirectly to the earning of profits or gains by the petitioner in the UAE. Every aspect of

the transaction was concluded in the UAE. The commission for the services of remittances offered by the assessee was also earned in the UAE. The activity performed by the liaison offices in India was only supportive of the transaction carried on in the UAE. It did not contribute to the earning of profits or gains by the petitioner in the UAE.

The High Court ruling has further been upheld by the Supreme Court in **Civil Appeal No. 9775 of 2011 dated April 24, 2020.**

16. *Production Resource Group (2018] 401 ITR 256 (AAR – New Delhi)*

The applicant is registered in Belgium, and it is engaged in the business of providing technical equipment and services for events including lighting, sound, video and LED technologies. It entered into a service agreement with the Organising Committee of the Commonwealth Games, Delhi, (OCCG), for a term commencing on 9 July 2010 and expiring on 30 October 2010, to provide services on a turnkey basis.

In terms of the agreement, the applicant rendered the services for two days, namely 3 October 2010, at the opening ceremony, and on 14 October 2010 at the closing ceremony of the Commonwealth Games Delhi, 2010. Its employees and equipment were in India for a period of only 66 days for the preparatory, installation and dismantling of equipment from 2 August 2010 to 24 October 2010.

As a consideration, OCCG agreed to pay fees of USD3.5 million, inclusive of the withholding and service tax, in installments. Four invoices were raised of which payments have been made against three after withholding tax at source and issued withholding tax certificates.

The Authority for Advance Ruling (AAR) held that the space provided by an organiser to a foreign service provider for rendering services relating to an event, i.e., lighting, sound, video, etc., constitutes a Permanent Establishment (PE) in India since the space is available at its disposal with exclusive right of access, controlled by it and used for its business. There was a clear link between the place of business and an identifiable geographical point, from where its business was done. The establishment need not be enduring or permanent in the sense that it should be in its control forever. The applicant had met each of the criteria for establishing a PE, namely, place of business, the power of disposition, the permanence of location, business activity and business connection.

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The AAR thus held that the payments received by the applicant for rendering lighting and searchlight services, earned through its PE in India, would be taxable as business profits under Article 7 of the India-Belgium tax treaty and under the provisions of the Income-tax Act, 1961 (the Act).

The AAR also held that the services rendered by the applicant were technical services since such services were complex and could not be availed without the assistance of highly trained technical personnel. However, the AAR held that by virtue of Most Favoured Nation (MFN) clause under the tax treaty, a restricted scope of Fees for Technical Services (FTS) [make available condition] provided under the India-Portugal tax treaty will be imported into the India-Belgium tax treaty. It cannot be said that the applicant had 'made available' the technical knowledge, experience, skill, knowhow or processes, which enable the development and transfer of a technical plan or technical design, and which enable the person acquiring the services to apply the technology contained therein. Therefore, the services provided by the applicant are not taxable as FTS.

Further payment for such services is also not in the nature of royalty since there is no assignment of any right to use the know-how, technical experience, skill, processes and methodology, or even the copyright, patent, trade mark, design or model, or any intellectual input comprised therein.

17. *Samsung Electronics Company Ltd v. DCIT [2018-TII-91-ITAT-DEL-INTL]*

The taxpayer is a tax resident of South Korea engaged in the business of manufacturing and sales of various categories of television, home appliances, telecommunication terminals, semi-conductors as well as other state of the art IT products for global markets. The taxpayer has two wholly owned subsidiaries in India i.e. Samsung India Electronics Private Limited (SIEL) and Samsung India Software Operations Private Limited (now known as Samsung R&D Institute India Bangalore Private Limited) (Samsung R&D).

During the relevant year, a survey was conducted, wherein it was found that SIEL was manufacturing the items under the technical assistance of the taxpayer for which the taxpayer used to receive FTS. The Assessing Officer (AO) observed that the Indian company's office was being used as place of management for South Asia operations by the parent company and therefore, the Indian company would constitute PE of the foreign parent company under Article 5(2)(a) of the India-Korea tax treaty and a part of

income from sales in South Asian countries such as Bangladesh, Nepal, Bhutan, and Maldives should be attributed to Samsung Electronics, Korea.

The AO held that the Indian company was acting as a dependent agent of the foreign company in terms of Article 5(5) of the India-Korea tax treaty, and the transactions between the two were not at arm's length. The AO held that expatriate employees create a PE of the taxpayer in India by rendering services to SIEL through its employees basis, and added an estimated income of 10 per cent on the remuneration paid to such expatriate employees during the years under consideration to determine the profits attributable to tax in India by applying Rule 10(iii) of the Income-tax Rules, 1962 (the Rules).

The Delhi Tribunal held that the services provided by the seconded employees of a foreign company to its subsidiary in India do not result in PE in India. The Tribunal held that the expatriate employees are only discharging functions of subsidiary towards the holding company for the benefit of the business of the subsidiary. It is to make the Global Business Management (GBM) understand the priorities and preferences of the Indian customers by providing India specific information to GBM which in turn then carry out research and development to develop India-specific products.

In the absence of proof as to any management activity of the taxpayer being conducted in India or it is established that the decisions relating to the products to be manufactured, pricing in the domestic markets, or the decisions relating to the launch of such products in India is taken by the taxpayer, the Delhi Tribunal observed that it is difficult to agree with the lower authorities that the taxpayer has been conducting the business in India through the expatriate employees. Consequently, the Tribunal held that there is no fixed place PE of the taxpayer constituted through the expatriated employees.

The Delhi Tribunal also held that, except stating that 10 per cent of the remuneration of these employees has to be assumed as the income of the taxpayer, there is absolutely no evidence that is placed on record by the AO to show that the taxpayer derived any business income in India by way of business through these expatriate and seconded employees. The Delhi Tribunal held that as there is no business activity that is conducted by the taxpayer through the expatriate employees, the question of estimated income does not arise.

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18. *FRS Hotel Group (LUX) S.A.R.L. [2018] 404 ITR 676 (AAR)*

The applicant is a company within the FRHI Group incorporated under the laws of and Duchy of Luxembourg. The applicant is the principal operator company of the FRHI Group outside of North America and provides services in connection with hotel management and including all services that are necessary for hotel operation, such as establishing hotel standards & policies, sales and marketing, centralised reservations, purchasing and certain other services as per the operational requirements of the hotel owners to meet the hotel brand requirements.

Bengal Ambuja Housing Development Limited (BAHDL) engaged the applicant to provide certain services in different phases of hotel development and operation so that the hotel property, i.e., Swissotel Kolkata can be developed and operated as per international standards. For the aforesaid purpose, the applicant and BAHDL entered into a centralised services agreement under which the applicant agreed to provide the specified services which are referred to as Global Reservation Services (GRS).

AAR ruling:

On a perusal of the terms of the agreement, it emerges that the different agreements are a part of the wholesome arrangement. The applicant has performed different functions in regard to the operation and management of the hotel in each of these agreements. These agreements contain references to each other at several places and are co-terminus with each other as well.

There is no doubt that the Indian hotel, Swissotel Kolkata is a fixed place. Upon a careful analysis of the terms of the various agreements, it was observed that the hotel is entirely at the disposal of the applicant. At the very stage of inception, i.e., the construction of the hotel, the applicant is called upon to oversee the design and construction of the property to ensure that it is compliant with the brand standards of the applicant. Once the hotel is constructed, its operation and management rest with the applicant.

Some of the core functions of the operation of the hotel such as sales and marketing, reservation, etc. have also been outsourced to the applicant. For providing such services, the hotel has undertaken to cooperate with the applicant to arrange for visas, licenses, authorisations for the applicant, its consultants, and employees, etc. to carry out such services at the hotel premises.

The applicant has, in substance, taken over all the important functions in relation to the operation and management of the Indian hotel. It is referred to as 'Operator' in the Hotel Management agreement, as 'Advisor' in the Centralized Services agreement and Hotel Advisory agreement, 'Licensor' in the Hotel License agreement and 'Consultant' in Technical Services agreement.

The fact is that irrespective of its different nomenclature in different agreements, the applicant is engaged in the complete management of its business operations in India. Therefore, the Indian hotel, Swissotel Kolkata, satisfies all the three tests and does constitute a fixed place PE of the applicant with respect to these incomes. The applicant is carrying on its entire business operations from this fixed place. The existence of a PE of the applicant in India gets established within the meaning of Article 7 of the India-Luxembourg tax treaty.

The final decision in respect of all of the important functions relating to the operation and management of the hotel is in the hands of the applicant. The arrangements of this kind can only exist in a principal to principal agreement. The Principal-agent relationship is completely non-existent in the facts of the case.

It was thus held that the payments received by the applicant from the Indian hotel for provision of GRS is chargeable to tax in India under Section 9(1)(i) of the Act as well as under Articles 5 and 7 of the India-Luxembourg tax treaty as business income. Further, it is attributable to the applicant's PE in India since the applicant is carrying on the entire business operations from the fixed place in India.

19. *Saudi Arabian Oil Company [2018] 405 ITR 83 (AAR)*

The applicant is a tax resident of Saudi Arabia and a fully integrated global petroleum and chemical enterprise. It is the world's largest crude oil exporter producing one in every eight barrels of world's oil supply. Presently, the applicant is making offshore crude oil sales to Indian refineries from outside India and payment is received by the applicant in a designated bank account outside India. It does not have any office in India.

To expand its India operations and for having a long-term presence, the applicant has established a subsidiary (Aramco India) in India. Though the primary object of the subsidiary is to provide procurement support services, it would also create awareness about Aramco and Saudi Arabian crude oil

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amongst crude buyers and refineries in India. Aramco India provides certain support services in furtherance of the sales operations. Aramco India will be helping in strategic sourcing and registration of major Indian oil and gas equipment manufacturers and engineering procurement and construction contractors, performing engineering and inspection evaluations, and plant audits for identified manufacturers and suppliers.

With regard to the negotiation of the material terms or conclusion of contracts with Indian customers as well as the signing of such contracts for and on behalf of the applicant, such activities will only be carried out by applicant's own employees based in Saudi Arabia. Aramco India started operations in India during Financial Year 2016-17, and in pursuance of the 'Service Agreement' dated 1 August 2016, it renders procurement, sourcing and logistic support and quality inspection support services to the applicant and other affiliates.

The AAR held that the Indian subsidiary of the applicant does not constitute a fixed place PE in India under Article 5(1) of India-Saudi Arabia tax treaty since the applicant is not carrying on its main business from the premises of its subsidiary and the fixed place is not available to the foreign company at its disposal. The foreign company's services are in the nature of support services. Further, the activities of the Indian subsidiary are duly compensated on an arm's length basis in accordance with the transfer pricing regulations.

Since none of the services are rendered by an employee of the applicant to its customers in India, the applicant does not have a service PE in India. Further, the Indian subsidiary of the applicant does not constitute an agency PE in India since the Indian company does not have the authority of a binding nature to conclude contracts which are specifically prohibited by the service agreement. The AAR held that exclusions provided under Article 5(4) of the India-Saudi Arabia tax treaty are applicable only if the applicant has a PE within the meaning of Articles 5(1) to 5(3) of the India-Saudi Arabia tax treaty.

20. *MasterCard Asia Pacific Pte. Ltd [2018] 406 ITR 43 (AAR)*

The applicant belongs to the MasterCard Incorporated group of companies. The applicant is the regional headquarter for the Asia Pacific, Middle East and Africa (APMEA) region and carries out the MasterCard group's principal business of transaction processing and payment related services under a

family of products including 'MasterCard', 'Maestro' and 'Cirrus' in the APMEA region.

Pursuant to Master License Agreements (MLA), the applicant provided services to APMEA customers (Banks, Financial Institutions, etc.). In terms of MLA, the applicant charges its customers' transaction processing fees relating to authorisation, clearing and settlement of transactions. The applicant also receives assessment fees for building and maintaining a processing network that serves the needs of customers globally, for setting up and maintaining a set of rules that govern the authorisation, clearing and settlement process for every payment transaction. Additionally, it receives miscellaneous revenue for the provision of services which are ancillary to the transaction processing activities.

The processing of electronic payment transactions involves steps such as initial level verification and validation of the transaction, authorisation, and thereafter clearing and settlement. Till December 2014, MasterCard International Incorporated (MCI) had a LO in India. Thereafter, the applicant had shut down the LO and had transferred that work to the Indian subsidiary [MasterCard India Services Private Limited (MISPL)]. The customer is provided with a MIP that connects to MasterCard's Network and processing centers. The applicant has a subsidiary in India and Indian subsidiary owns and maintains the MIPs placed at the customers' locations in India.

In view of the above facts, the applicant filed an application before the AAR to determine the taxability of the services rendered in this regard.

The AAR while dealing with an issue whether the global payment solution provider company facilitating various stakeholders worldwide to use electronic forms of payment has a PE in India and whether payments for such services are taxable in India, held as follows:

The applicant has MasterCard Interface Processor (MIP) and MasterCard's Network to provide transaction processing services to its customers in India. This constitutes a fixed place PE in India under the India-Singapore tax treaty as the applicant is carrying out its business of facilitation of authorisation of the transaction through such MIPs and network which are situated in India and are at the disposal of the applicant. The AAR also held constitution of service PE on account of applicant's employees visiting India and constitution of Dependent agent PE on account of Indian subsidiary securing orders for the applicant.

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Prior to December 2014, MCI had accepted its PE in India under MAP and attributed 100 per cent of income from transaction processing activity in India to such PE. However, after December 2014, with all operations remaining same, the TP report mentioned that the Indian subsidiary was undertaking only support functions and not actual transaction processing, which MCI was doing earlier. Thus, it was observed that there are some functions and risk related to transaction processing which were earlier carried out by MCI in India and are still carried out by Indian subsidiary but not shown in the Functions, Assets, and Risk (FAR) of the Indian subsidiary. Therefore, the AAR held that the subsidiary company creates a PE of the applicant in India.

A portion of the fees received by the applicant has also held to be categorised as royalty under the India-Singapore tax treaty. Further, AAR also clarified that as the payment is effectively connected with the PE in India, it would be taxable as business income under the India-Singapore tax treaty and not as royalty.

The AAR held that the relation between final consumer and the applicant is of use of a standard facility and hence, transaction processing service rendered by the applicant cannot be taxed as FTS under the India-Singapore tax treaty. With respect to services other than transaction processing services, they are in the nature of warning bulletin fees for listing invalid or fraudulent accounts either electronically or in paper form, cardholder service fees, program management services, account and transaction enhancement services, holograms and publication fees and advisory services, etc. AAR observed that these services are not standard facility and these specific services are required to be rendered to a specific customer who has requested for such services. Hence, these are technical services. However, they do not 'make available' technical knowledge, experience, skill, know-how to the service recipient. Hence, they cannot be classified as FTS under Article 12 of the India-Singapore tax treaty.

With regard to the attribution of income to the Indian PE, the AAR agreed that all the revenues received by the applicant from customers in India would not be attributed to the Indian PE since significant activities are also carried out by the applicant outside India. Thus, there is a need for attribution which is required to be done by the AO. On such attribution of income to the PE, the tax is required to be withheld at full applicable rate at which the non-resident is subjected to tax in India.

21. Lufthansa German Airlines v. Deputy Commissioner of Income-tax [2004] 90 ITD 310 (Delhi)

The taxpayer an Indian branch of a German airline (Airline) was engaged in the business of operation of aircraft in the international traffic.

The Airline being a member of IATP, also extended/received minimal technical facilities in the nature of line maintenance facilities to/from other IATP members. These technical facilities were extended to assist other IATP member airlines as a means for collaboration amongst them and for which, no money was paid out or received but only notional credits and debits were received or given through the pool's accounting mechanism.

In its tax return in India, the Airline claimed that the amount received from various IATP member airlines for the aforesaid services rendered in India was not liable to tax in India under Article 8 of the DTAA between India and Germany .

The (AO held that the notional amount received through the pool account was taxable in India as business income of the Airline. It observed that services rendered by the Airline were a separate business activity rendered by exploiting its existing idle resources in India and the Airlines' business was not affected if it did not render such services.

The CIT(A) upheld the order of the AO. The Airline then preferred an appeal to the Tribunal. The Delhi Bench of the Tribunal held that amount received by the Airlines from the pool arrangement was not taxable in India under Article 8 of the DTAA between India and Germany.

The Tribunal observed that under Article 8 of the DTAA between India and Germany, the two items of income not liable to tax in India were, profits from operation of aircrafts and profits from participation in a pool, joint business or an international operating agency because these profits were taxable only in the Contracting State in which the place of the effective management of the Airline was situated.

The Tribunal noted that the IATP was the only known pool in the international aviation industry and there was reciprocity in rendering/ availing the services to/from the IATP member airlines. It, therefore, held that the Airline participated in the IATP as envisaged under Article 8 of the DTAA between India and Germany and hence profits from such participation would not be taxable in India.

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The Tribunal distinguished its earlier ruling delivered in the case of *British Airways Plc v Deputy Commissioner of Income tax [2002] 80 ITD 90* in the context of the India-UK DTAA based on facts and held that the same was not applicable to the instant case.

The Tribunal noted the following facts of difference between British Airways case and the instant case:

- (a) There was no reciprocity of services between the British Airways and other airlines because it only provided services to other airlines and did not avail such services from other airlines and therefore it cannot be said to be a participation in a 'pool'
- (b) The British Airways had a separate office set up in India providing services to various airlines for a price. Hence, such services were a commercial activity not forming part and parcel of the operation of aircrafts in international traffic of British Airways.
- (c) British Airways had a permanent establishment in India (in the form of a branch office in India) whose income was taxable in India, as the same was not covered under India-UK DTAA.
- (d) The words 'pools of any kind' appearing in Article 8 of the India-UK DTAA were interpreted by the Tribunal by taking the dictionary meaning of the word pool ignoring IATP Manual because the British Airways submitted only certain extracts of the IATP Manual which did not prove the existence of IATP Manual, which was internationally recognized.
- (e) The agreement between British Airways and other airlines were not as per the IATP Manual in the prescribed form and also the charges for the services rendered were not as per the IATP Manual but in the case of the Lufthansa airline, both the agreement and charges were in accordance with the IATP Manual.

The Tribunal also held that income from participation in Pool activities could not be brought to tax in India under Article 7 (Business Profits) read with Article 5 (Permanent Establishment) since, such income was specifically dealt with by Article 8 of the DTAA between India and Germany.

The Tribunal observed that in the instant case, the services rendered and the charges received were in accordance with the IATP Manual. The Tribunal, hence, held that the profits of the Airline from participation in a pool was

protected under Article 8 of the DTAA between India and Germany and could not be brought to tax in India.

22. *Bellsea Ltd v. ADIT [ITA No 5759/Del/2011] – Taxsutra.com*

The taxpayer is a Cyprus based company which was awarded contract by another foreign entity Allseas Marine Contractors S.A, (AMC) for placement of rock in seabed for laying of gas pipelines and providing umbilical for sub structures in oil and gas field developed at Krishna Godavari Basin.

AMC was awarded a contract from the Reliance group and Niko Resources for extraction of gas and for laying of gas pipeline. In order to carry out its contract work AMC has given a contract to the taxpayer for the placement of rock in the oil and gas field.

Under the terms of the contract, the work was intended to commence from 4 January 2008 which has been mentioned as 'effective date' in the contract. Under the said contract itself, the completion of the work was reckoned from the date issuance of completion certificate by AMC which was 30 September 2008.

The contract lasted for less than 12 months which is the threshold period for the establishment of PE in India in terms of installation PE under Article 5(2)(g) of the India-Cyprus tax treaty. Therefore, it was claimed by the taxpayer that no income earned from such contract can be attributed or taxed in India.

The Delhi Tribunal held that the taxpayer does not constitute Installation PE under Article 5(2)(g) of the India-Cyprus tax treaty since threshold period of 12 months have not exceeded. The Delhi Tribunal observed that preparatory work for tendering purpose before entering into contract cannot be counted while calculating the threshold period.

Accordingly, no income of the taxpayer on the contract executed by the taxpayer in India is taxable in terms of Article 7 of the India-Cyprus tax treaty.

23. *Samsung Electronics Company Ltd v. DCIT [2018-TII-91-ITAT-DEL-INTL]*

The taxpayer is a tax resident of South Korea engaged in the business of manufacturing and sales of various categories of television, home appliances, telecommunication terminals, semi-conductors as well as other state of the art IT products for global markets. The taxpayer has two wholly

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owned subsidiaries in India i.e. Samsung India Electronics Private Limited (SIEL) and Samsung India Software Operations Private Limited (now known as Samsung R&D Institute India Bangalore Private Limited) (Samsung R&D).

During the relevant year, a survey was conducted, wherein it was found that SIEL was manufacturing the items under the technical assistance of the taxpayer for which the taxpayer used to receive FTS. The Assessing Officer (AO) observed that the Indian company's office was being used as place of management for South Asia operations by the parent company and therefore, the Indian company would constitute PE of the foreign parent company under Article 5(2)(a) of the India-Korea tax treaty and a part of income from sales in South Asian countries such as Bangladesh, Nepal, Bhutan, and Maldives should be attributed to Samsung Electronics, Korea.

The AO held that the Indian company was acting as a dependent agent of the foreign company in terms of Article 5(5) of the India-Korea tax treaty, and the transactions between the two were not at arm's length. The AO held that expatriate employees create a PE of the taxpayer in India by rendering services to SIEL through its employees basis, and added an estimated income of 10 per cent on the remuneration paid to such expatriate employees during the years under consideration to determine the profits attributable to tax in India by applying Rule 10(iii) of the Income-tax Rules, 1962 (the Rules).

The Delhi Tribunal held that the services provided by the seconded employees of a foreign company to its subsidiary in India do not result in PE in India. The Tribunal held that the expatriate employees are only discharging functions of subsidiary towards the holding company for the benefit of the business of the subsidiary. It is to make the Global Business Management (GBM) understand the priorities and preferences of the Indian customers by providing India specific information to GBM which in turn then carry out research and development to develop India-specific products.

In the absence of proof as to any management activity of the taxpayer being conducted in India or it is established that the decisions relating to the products to be manufactured, pricing in the domestic markets, or the decisions relating to the launch of such products in India is taken by the taxpayer, the Delhi Tribunal observed that it is difficult to agree with the lower authorities that the taxpayer has been conducting the business in India through the expatriate employees. Consequently, the Tribunal held that there

is no fixed place PE of the taxpayer constituted through the expatriated employees.

The Delhi Tribunal also held that, except stating that 10 per cent of the remuneration of these employees has to be assumed as the income of the taxpayer, there is absolutely no evidence that is placed on record by the AO to show that the taxpayer derived any business income in India by way of business through these expatriate and seconded employees. The Delhi Tribunal held that as there is no business activity that is conducted by the taxpayer through the expatriate employees, the question of estimated income does not arise.

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The Delhi Tribunal also held that, except stating that 10 per cent of the remuneration of these employees has to be assumed as the income of the taxpayer, there is absolutely no evidence that is placed on record by the AO to show that the taxpayer derived any business income in India by way of business through these expatriate and seconded employees. The Delhi Tribunal held that as there is no business activity that is conducted by the taxpayer through the expatriate employees, the question of estimated income does not arise.

24. *DCIT v. Domino's Pizza International Franchising Inc. [2018] 171 ITD 321 (Mum)*

The taxpayer, being a tax resident of the United States of America (USA), filed its return of income for Assessment Year 2012-13 declaring total income of INR16.53 million. The taxpayer entered into Master Franchises Agreement (MFA) with Jubilant Food Works Limited (Jubilant) for the franchise of Domino's Pizza Store. The said MFA provide certain store/consultancy services to Jubilant.

In terms of the agreement, Jubilant paid store opening fees for those services. The franchise fee is received by the taxpayer from Jubilant for ongoing use of Dominos trademark and also for the right to use the new technology, new product development and system improvement. As per MFA, the taxpayer is entitled to charge 3 per cent of the sales of store of Jubilant and further 3 per cent on sale of their sub-franchise store.

The taxpayer claimed that Jubilant has complete independence with regard to its business dealing and transaction and does not act on behalf of the taxpayer or under its instruction. The taxpayer has offered the income received from Jubilant in the nature of royalty taxable at 10 per cent under the tax treaty. The taxpayer has also offered the income from franchise fee and consultancy services provided to Jubilant for opening of store.

The AO held that Jubilant is totally dependent upon the taxpayer. The taxpayer has exclusive franchise right in India. Jubilant is not allowed any other activities other than activities prescribed in the agreement. Further, the quality of material and equipment used has to be approved by the taxpayer. The expenses on advertisement and marketing are also carried out in accordance with the provision of agreement. On the basis of above observation, the AO held that Jubilant does not have economic independence and its modus-operandi is not on principal to principal basis.

Therefore, Jubilant is dependent agent for the purpose of determining a PE. The AO treated the receipt from operations in India as a business receipt taxable at 40 per cent.

The Delhi Tribunal observed that the Sub-Franchise Agreement (SFA) is executed between Jubilant and sub-franchise and not between the taxpayer and sub-franchise. The Delhi Tribunal on perusal of these facts from the copy of MFA and SFA observed that the assertion of taxpayer is correct.

The Delhi Tribunal further observed that the SFA is signed on behalf of Jubilant and Travel Food Services Pvt. Ltd. for Mumbai and Delhi location. The profit and loss from the business belongs to Jubilant or sub-franchise. It has been observed that certain clauses and the agreement entitles the taxpayer to examine the accounts, approve suppliers and allowing control over advertisement, however, the Jubilant or sub-franchise are not storing any goods on behalf of the taxpayer. From the sub-franchise, the taxpayer is entitled to only royalty and store opening fees.

On a perusal of Article 5 of the India-U.S. tax treaty it has been observed that none of the conditions prescribed under clause (a) to clause (l) of Article 5(2) are attracted. The AO has relied upon Article 5(4) of the India-U.S. tax treaty. However, the Indian company has no authority to maintain in India its stock or goods or merchandise on behalf of the taxpayer. No activities are carried out by the Indian company on behalf of the taxpayer. Therefore, it does not constitute PE in India.

25. *Nokia Networks OY v. JCIT [2018] 65 ITR(T) 23 (Del)*

The taxpayer, a company incorporated in Finland, was engaged in the manufacturing of advanced telecommunication systems and equipment (GSM Equipment) which were used in fixed and mobile phone networks. These GSM equipment was also used in trading of telecommunication of hardware and software.

During the year 1994, the taxpayer had established a Liaison Office (LO). Subsequently, on 23 May 1995, a wholly owned subsidiary was incorporated. During the period when LO was in operation, the GSM equipment manufactured in Finland were sold to Indian telecommunication operators from outside India on principle to principle basis under independent buyer-seller arrangements as well certain contracts for installation was also entered into.

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Subsequent to the incorporation of subsidiary in May 1995, the installation activities were carried out by the Indian subsidiary under its independent contracts with the Indian telecommunication operators. Various contracts were entered into by the taxpayer through which the installation activities were performed by the Indian subsidiary under separate agreement entered into between Indian subsidiary and the Indian cellular operators.

In so far as supply/contracts of equipment entered into with two contractors, the same were signed prior to incorporation of Indian subsidiary in 1995. The installation activities qua these contracts earlier form part of the original equipment supply contract but later on were subsequently assigned to the subsidiary.

For the offshore supply of equipment, the taxpayer did not file return of income in India for Assessment Years 1997-98. The taxpayer claimed that it does not have a PE in India, and therefore, income was not taxable in India. Further, it does not have any business connection in India as it had supplied goods to Indian telecom operators on principle to principle basis, no income could be taxed in India.

The Delhi Tribunal dealt with issues with respect to PE, business connection and profit attribution. The majority (two) members of the Special Bench of the Delhi Tribunal held that Indian subsidiary of the taxpayer does not constitute a fixed place PE under the India-Finland tax treaty since place of business is not at the disposal of the taxpayer. Activities of the taxpayer in India were purely pertaining to network planning, negotiation and signing of contracts before offshore supply of equipment and sale of goods. Further, the taxpayer does not have agency PE in India under the India-Finland tax treaty since the Indian subsidiary company had not negotiated or concluded any contract of supply of equipment on behalf of the taxpayer.

When installation activity was not carried out by the taxpayer in India and was carried on by Indian subsidiary on principal to principal basis with the customers, there was no question of examining the installation activity for purpose of PE. Thus, provision of Article 5(7) of the India-Finland tax treaty will also not apply.

Further, the taxpayer does not have 'business connection' in India under the Act since the title of the goods was transferred outside India and the payments were received by the taxpayer outside India.

The concept of 'virtual projection' has to be seen in the context of any of the ingredient of PE enshrined in Article 5 of the India-Finland tax treaty. The

concept of virtual projection does not mean that even without a fixed place, virtual projection itself will lead to an inference of a PE. If on a facts there was no establishment of a fixed place and disposal test was not satisfied, then virtual projection itself cannot be held to be a factor for creation of a PE.

However, third member of the Special Bench of the Delhi Tribunal held that the taxpayer was having a 'business connection' in India by way of its Indian subsidiary which was acting for the furtherance of the business interests of the taxpayer in India. The Indian company was a proxy/virtual projection of foreign parent company. The Indian subsidiary of the taxpayer constitutes a fixed place PE under the India-Finland tax treaty. Therefore, 35 per cent of global profit on sales can be reasonably attributed to the PE in India.

26. Decca Survey Overseas Ltd. U.K. Mumbai v. ITO I.T.A. No.8506/BOM/90 and 8628/BOM/91 dated 18 March 2004 (Mum)

The taxpayer, a company incorporated in the U.K., was engaged in the business of hydrographic surveying activities. During the year under consideration it had entered into contracts with an Indian company and two foreign companies for carrying out survey and positioning work off-shore India beyond the exclusive economic zone i.e. 12 nautical miles. In connection with the contracts the Company had sent its specialized equipment and personnel to the off-shore barges as and when required. In its tax return, the Company claimed that the amounts received from the three companies was not taxable in India in the absence of a Permanent Establishment (PE) taking shelter under Article VII of the DTAA between India and U.K⁶.

The AO held that the service was in the nature of a technical service and therefore the payments would fall under Article XIII "Fees for Technical Services" (FTS) of the DTAA between India and U.K. The AO further rejected the Company's contention that the payments were assessable as "Business Profits" under Article VII on the ground that Article XIII being a special would override Article VII of the DTAA between India and U.K.

Without prejudice to his stand that the payments are assessable as FTS the AO has also dealt with and dismissed the Company's contention that it did not have a PE in India. The AO was of the view that the Company would have a PE within the meaning of Article V (2)(h) of the DTAA between India

⁶ Please note that this decision relates to the old India-U.K. DTAA

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and U.K, which incorporated within its fold a mine, quarry, or any other place of extraction. The AO held that as the Company was engaged in the business of extraction of oil it would fall under Article V (2)(h) of the DTAA between India and U.K. The AO was also of the view that as the Company was in India on and of since 1980 it would have a PE under Article V (2)(j) of the DTAA between India and U.K, which brought within its fold construction and supervisory activities, which last for more than six months. The AO accordingly proceeded to assess the payment made by the Indian company under Section 115A of the Act and the payment made by the non-resident companies under Section 44BB of the Act.

The CIT(A) was of the view that the services were in the nature of technical services. The CIT(A) also held that the Company had a PE in India within the meaning of Article V (2)(j) of the DTAA between India and U.K . The CIT(A) was however of the opinion that only the profits attributable to the PE were taxable in India and for that limited purpose remanded the matter back to the AO.

The company preferred an appeal to the Tribunal .

The Tribunal held that the payments received are to be assessed under Article XVII of the DTAA between India and U.K as FTS. The Tribunal dismissed the company's contention that technical services are predominantly based on personal skills of a performer of arts in which the use of equipment is incidental. In the Company's case the use of equipment was the substantial part of the contract and therefore it could not be classified as technical service.

The Tribunal on a perusal of the contracts noted that the company made available personnel and equipment and performed survey services. The Tribunal noted that the equipment and personnel are employed together in the rendering of service and both form an important part of the service rendered. The Tribunal thus concluded that the service rendered was in the nature of a technical service. The Tribunal also held that it would not matter if the business of the company was itself to render technical services as even if that be so the more appropriate Article would be the special Article i.e. Article XIII.

The Tribunal therefore held that the payments were in the nature of FTS and would be assessed under Article XIII of the DTAA between India and U.K.

Though in light of the decision above the issue of whether the company had a PE in India would not be very relevant but in order to do justice to the

arguments put forward the Tribunal has also dealt with the submissions put forth by the company and the Department. The Tribunal has held that the company could not be held to have a PE under Article V (2)(h) of the DTAA between India and U.K by only rendering technical service to persons owning rigs etc. The rig would merely be a place where the service is rendered and not a PE.

As regards Article V (2)(j) of the DTAA between India and U.K, the Tribunal noted that the first requirement that the PE should be in India was satisfied as the rig was in the extended definition of India i.e. within the extended boundary of India encompassing 12 nautical miles. As regards the other condition that the activity constituting the PE should last for more than six months, the Tribunal relying on the OECD commentary and the Memorandum to the new DTAA signed by India and U.K. noted that the period of six months has to be computed with reference to each project and not from the cumulative presence in India. The Tribunal observed that as both the cumulative conditions were not satisfied there would not be a PE under this clause either.

The Tribunal thus held that the income was taxable in India under Article XIII of the DTAA between India and U.K.

27. BKI / HAM V.O.F. v. ACIT [2001] 70 TTJ 480 (Del).

This case pertains to assessment year 1995-96. The taxpayer, a partnership firm was incorporated in Netherlands with limited liability. It executed a sub-contract with Hyundai Heavy Industries Limited (HHI) for dredging of a trench for laying Second Bassein Hazira Trunk Pipeline Project. Subsequently, the trench was to be filled in after the pipeline was laid in the trench. For the assessment year 1995-96, the taxpayer filed a return of income, on cash basis in respect of payments received by it from HHI. Based on the provisions of the Indo-Netherlands DTAA, the taxpayer claimed the income to be non-taxable in India and filed a 'Nil' return.

The AO held the income to be taxable on the basis that under the provisions of Article 5(3), the taxpayer had a PE in India since the activities carried on in India exceeded a period of six months. He contended that the period of six months for determination of presence of a permanent establishment should be counted from the date of arrival of the first dredger i.e., on 16 December 1993.

The CIT(A) upheld the order of the AO. Based on the documentary evidence, the Tribunal found that the permanent establishment commenced from 27

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December, 1993 and ended on 12 June, 1994. The plant and machinery were completely demobilised by 12 June, 1994 clearly indicating that the taxpayer had wound up its entire operations in India by that date. Thus, even on adopting the AO's contention, that the period of six months for determination of a PE should be counted from the date of arrival of the first dredger, the period of six months was not completed. As the project did not continue for more than six months, there was no PE in India.

The Tribunal held that the stand of the taxpayer was also supported by an order issued by the AO under Section 197 of the Act where after due deliberations, a no objection certificate was granted to the taxpayer to remit the amount without deduction of tax at source. Article 5(3) provides that a building site or construction, installation or assembly project constitutes a PE only where such site or project continues for a period of more than six months. The Tribunal held that the PE at Bombay was of a preparatory or auxiliary character as envisaged in article 5(4)(e) and could not make the income from the contract with HHI taxable. As the duration of activities under the sub-contract with HHI did not exceed a period of six months, there was no PE in India and the business profits of the taxpayer could not be taxed in India.

28. CIT v. Tata Iron & Steel Co. Ltd. (2001) 116 Taxman 403 (Bom.)

This case pertains to the assessment years 1985-86 and 1986-87. Under the provisions of the DTAA between India and the Federal Republic of Germany entered into under the Indian Income-tax Act, 1922, and ratified under Act, "Royalties and FTS" were exempt from tax incidence in India.

The DTAA was subsequently amended and "Royalties and FTS" were made taxable. The protocol that introduced these amendments was ratified on 10 July, 1985 and was notified on 26 August, 1985. Under the amended protocol the source country could impose tax for "Royalties and FTS" paid to German residents.

The taxpayer company had entered into separate agreements with three German companies prior to the date of ratification of the protocol and part payments was made to these companies during the financial years 1984-85 and 1985-86. The company contended that as the agreements were entered into prior to the date of ratification, the payments would not be subject to any tax incidence in India. The AO did not accept this contention.

However, the CIT(A) reversed this order. The Tribunal confirmed the order of the CIT(A) that, the amendment in this treaty would not apply to contracts

executed prior to the date of ratification of the protocol, viz., 10 July, 1985. The tax authorities moved a rectification application before the Tribunal on the ground that, there was a mistake apparent from record. The Tribunal rejected the Miscellaneous Application and held that there was no mistake apparent from record.

In a reference the High Court held that there was no mistake apparent from records, as the amendment introduced by the Protocol to the DTAA would not apply to contracts executed before the date of its ratification.

29. Bombay Burmah Trading Corpn. Ltd. v. Asst. CIT [2002] 82 ITD 531 (Mum)

The taxpayer, a company, earned income in Tanzania by engaging in the business of sale of tea. The company claimed exemption of the income derived from the permanent establishment (PE) in Tanzania, as the same would be taxed in Tanzania and not in India in view of Article 7 of the DTAA between India and Tanzania.

The AO observed that the Company conducted similar business in India and through its head office in India controlled the activities of the PE in Tanzania and therefore the income earned was taxable as business profit in India.

The CIT(A) upheld the order of the AO as the Company had in the preceding years claimed set-off of loss arising to the PE in Tanzania while computing total income for Indian taxation.

The Tribunal held that

- (a) profits attributable to the PE in Tanzania were taxable in India and also in Tanzania in view of Article 7 of the DTAA between India and Tanzania.
- (b) taxation of such income would not result in double taxation as Article 25 of the DTAA between India and Tanzania provides for the mechanism to eliminate double taxation by credit for taxes paid in Tanzania.

The Tribunal rejected the claim of the Company and upheld the taxation of the income attributable to the PE in Tanzania.

30. Speciality Magazines P. Ltd., In re 274 ITR 310 (AAR)

The applicant, an Indian company, was an advertisement agent of a UK based company (TENL) engaged in the business of publishing magazines in London. The Applicant entered into an advertisement contract with TENL

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whereby the Applicant accepted orders for advertisement for TENL subject to the confirmation of TENL.

TENL directly raised invoices outside India on the Indian advertisers in US dollars for the advertising charges. Though the advertising charges were payable in US dollars, TENL extended the facility to the customers to pay the money to the Applicant in Indian currency. The Applicant was granted the authority to collect the charges in Indian currency and remit the same in US dollars to TENL.

Under the agreement, the Applicant was entitled to a commission of 15 per cent on the gross value of the invoices raised by TENL on the Indian advertisers. The commission was to be received in foreign currency from TENL. The Applicant was barred from entering into any advertisement contract with any competitor of TENL except with the approval of TENL.

The Applicant had entered into advertisement contracts with other entities as well, from which, it received its commission in Indian rupees. The Applicant's record showed that it had always canvassed orders for TENL from overseas and that the income from TENL constituted 70 to 78 percent of the applicant's income.

The Applicant sought a ruling from the AAR as to whether any income would be deemed to accrue or arise in India in the hands of TENL in respect of the advertising charges payable by the applicant to TENL in foreign currency.

The AAR observed that the taxability of the advertising charges in the hands of TENL would depend upon whether TENL had any business connection under the Act and/or whether the Applicant was a PE in India as per the DTAA between India and UK.

The AAR relied on the inclusive definition of business connection in Explanation 2 to Section 9(1)(i) of the Act and observed that TENL had a business connection in India because the Applicant acting on behalf of TENL –

- (a) had habitually exercised, the authority to conclude contracts on behalf of TENL; and
- (b) had also habitually secured orders mainly or wholly for TENL.

The AAR observed that the following essential features of business connection based on the Supreme Court decisions⁷ were evident: -

- (a) a real and intimate relation existed between the activities carried on outside India by TENL and the activities of the Applicant within India;
- (b) such relation contributed, directly or indirectly, to the earning of income by TENL in its business
- (c) there was a course of dealing/continuity of relationship and not a mere isolated/stray nexus between the business of TENL and the Applicant, which furnished a strong indication of the existence of a business connection in India between TENL and the Applicant.

As regards the Applicant's constituting a PE of TENL as per Article 5 of the DTAA between India and UK, the AAR observed based on paragraph 5 of Article 5 of the DTAA between India and UK that TENL carried on business in India through the applicant who was an agent of an independent status but whose activities were not carried out wholly or almost wholly on behalf of TENL.

The AAR observed that the applicant looked after the entire business of TENL and the income of the Applicant was received mainly from TENL. Yet, the applicant did not constitute the PE of TENL because TENL was not the sole client of the applicant, even though the applicant was the sole agent of TENL.

The AAR observed that as the applicant earned only 70 to 78 per cent of its income from TENL and the balance income from its other clients, it could not be held that the activities of the applicant were carried out wholly or almost wholly for TENL.

The AAR thus held that TENL had a business connection in India under the Act but had no PE under the DTAA between India and UK and as the provisions of the DTAA between India and UK prevailed over the provisions of the Act, the advertising charges received by TENL from the Applicant, which constituted business income of TENL, would not be taxable in India.

⁷ CIT v R. D. Aggarwal & Co [1965] 56 ITR 20 and Anglo French Textile Co. Ltd v CIT (No. 2) [1953] 23 ITR 101, 108

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31. Gentex Merchants (P.) Ltd v Deputy Director of Income-tax (International Taxation) [2005] 94 ITD 211 (Kol)

The taxpayer, a company was an owner of certain premises. The Company entered into an agreement (the WF agreement) with a US company for providing advice and other services, designs etc for development of water features at its premises.

Under the WF agreement the work was to be performed in various phases. The US company provided schematic ideas and technical designs, drawings and information on basis of which the Company executed and installed water features. The US company had to ensure that water features executed by the contractors of the company conformed to its drawings, designs and specifications.

The company made an application under Section 195(2) of the Act for nil withholding in respect of the payment to be made to the US company under the WF agreement. The company was of the view that no income accrued to the US Company in India in respect of the payment made to the US Company under the WF agreement. The AO passed an order under Section 195(2) of the Act treating the payments made to the US company under the WF agreement as fees for included services and directed the company to withhold tax at the rate of 15 percent.

The CIT(A) upheld the AO's order. The Company preferred an appeal to the Kolkata Tribunal. The Kolkata Bench of the Tribunal dismissed the appeal of the company. The Tribunal relied on the WF agreement and noted that various phases contemplated therein were composite and cumulative, with every phase being related to each other and the contract was a single composite contract. The US company was to undertake the work on a cumulative basis for which composite non-divisible fees were to be paid.

The Tribunal observed that the substance of the WF agreement was that the US company not only advised the company but in fact it also prepared all the technical designs/drawings necessary for implementing the water features, delivered the same to the company and assisted the company in actual erection and commissioning of water features. The Tribunal observed that Article 12(4)(b) of the DTAA was attracted the moment a resident of one country made available technical knowledge, experience or transfers a technical plan/design to a resident of the other country. It was not material as to whether the company acquired any technical knowledge, know-how, technical plan or design on an outright basis.

Further, the transfer referred to in Article 12 of the DTAA did not contemplate an absolute transfer of rights, title, interest and ownership in the technical plan/design. It covered transfer of technical plan/ designs for mere use and benefit for the resident of the other country.

The Tribunal held that under the WF agreement the US company transferred technical plan/design for the sole use by the company in India. Hence, the payment made by the company to the US company was squarely covered within the definition of 'fees for included services' and the company was liable to withhold tax at the rate of 15 per cent on the payment made to the US company.

32. DCIT v. Boston Consulting Group Pte. Ltd. [2005] 94 ITD 31 (Mum)

The taxpayer, a company based in Singapore, carried out its business of rendering strategic consulting services such as business strategy, marketing and sales strategy, portfolio strategy etc. from a branch office PE in India. During the Assessment Year (AY) 1997-1998 the company filed a loss return and claimed a deduction for expenses incurred on professional services rendered to Indian and foreign clients.

The AO was of the view that the receipts from Indian clients being in the nature of FTS, though the income was computed under Article 7(3) "Business Profits" of the DTAA between India and Singapore, the deductions available were subject to and limited to the deductions under the Act and therefore the provisions of Section 44D read with Section 115A of the Act were attracted.

The CIT(A) held that the receipts were not FTS as defined in Article 12 of the DTAA between India and Singapore and therefore the taxability would have to be decided under Article 7 "Business Profits" to the extent they were attributable to the PE in India. Article 7(3) which deals with computation of profits of the PE provides that the net profits are taxable after deducting expenditure incurred and as the company has suffered a loss there was no "income" to be determined/taxable. The CIT(A) therefore, did not deal with the issue of computation of income.

The tax authorities preferred an appeal to the Mumbai Tribunal.

The Mumbai Bench of the Tribunal held that it was a settled issue that whenever there was a conflict between the provisions of the DTAA and the Act, the provisions of the DTAA would prevail. Once the company was covered by the provisions of the DTAA it was not open to the tax authorities to assess the company under the provisions of the Act.

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The Tribunal observed that Section 44D of the Act provided for taxation of FTS and royalties on gross basis without any deduction of expenses and Section 115A of the Act provided for a lower rate of tax on FTS and royalties. These sections have to be read in conjunction and not in isolation. The non-deduction of expenses was coupled with a special rate of tax on gross basis for FTS and royalties. Further, Article 12 of the DTAA provided for a lower rate of tax on the gross income of FTS and royalties.

The Tribunal held that Sections 44D and 115A of the Act and Article 12 of the DTAA were similar to an extent but were independent provisions and hence had to be applied mutually and exclusively.

The Tribunal observed that the consultancy services were in the nature of strategy and business consulting to improve the performance of the company and hence were non-technical services i.e. not containing technology. If the income could not be taxed under Article 12 of the DTAA it could not be taxed under Section 44D/115A of the Act either.

The Tribunal held that the consultancy services did not fall in the definition of FTS under Article 12 of the DTAA. Further the limitation of deduction of expenses under Section 44D of the Act did not apply in respect of the receipts, which were not FTS under the DTAA and the profits of which had to be computed under Article 7(3) of the DTAA.

33. Ishikawajma Harima Heavy Industries Ltd. v. DIT [2007] 158 TAXMAN 259 (SC)

The taxpayer, a foreign company incorporated in Japan formed a consortium with five other enterprises. The consortium was awarded a turnkey contract from Petronet LNG Limited (Petronet) for setting up Liquefied Natural Gas (LNG) receiving, storage and regasification facility in India to be completed in 41 months. The contract signed in India clearly specified the role/responsibility and the consideration to be paid separately for the respective work of each enterprise in the consortium. The description of the work allotted to the taxpayer was categorized as (i) offshore supply (ii) offshore services (iii) onshore supply (iv) onshore services and (v) construction and erection. The price for items (i) and (ii) was payable in US dollars. The price for items (iii), (iv) and (v) was payable partly in US dollars and partly in Indian rupees.

In offshore supply of equipment and material, the goods were supplied on CFR basis from outside India. The property in goods passed to the Petronet on high seas outside India. Offshore services comprised of design and

engineering including detail engineering in relation to supplies, services and construction and erection and any other services to be rendered from outside India.

The taxpayer preferred advance ruling before the AAR

AAR ruling

The AAR held that the applicant had a business connection/PE in India. The AAR relying on Article 7(1) of the Tax Treaty and Para 6 of the Protocol to the Tax Treaty observed that the profits of the Japanese enterprise constituting PE in India would be taxable in India to the extent the profits are directly or indirectly attributable to the PE. It further observed that profits would be attributed to the PE even if the contract or order relating to the sale or provision of goods or services was made or placed directly with the overseas head office rather than with the PE.

The offshore supply of equipment and materials was a part of a composite contract involving various operations within and outside India and so the profits from offshore supply to the extent it could be attributed to the operations in India would be deemed to accrue or arise in India and would be taxable in India

The AAR relying on the provision of Section 9(1)(vii) of the Act observed that the price paid for offshore services would be deemed to accrue or arise in India as fees for technical services and could not be related to construction, assembly, mining or like projects undertaken by the taxpayer. Relying on Article 12 (2) of the Tax Treaty, it observed that as the taxpayer was a beneficial owner of the offshore services, the price paid for offshore services was taxable on gross basis at 20 per cent. Further, the taxpayer would not be eligible to claim deduction for any expenses from the consideration received for offshore services.

The AAR concluded that the price paid to the taxpayer by Petronet for the offshore supply and offshore services was taxable in India under the Act as well as under the Tax Treaty.

Supreme Court's ruling

Turnkey Project need not mean entire contract is integrated one and taxable in India

The project was a turnkey project but the same by itself would not mean that even for the purpose of taxability the entire contract must be considered to

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be an integrated one so as to make the taxpayer pay tax in India. The taxable events in execution of a contract might arise at several stages in several years. The liability of the parties might also arise at several stages. Obligations under the contract were distinct ones. Supply obligation was distinct and separate from service obligation. Price for each of the component of the contract was separate.

Similarly offshore supply and offshore services had separately been dealt with. Prices in each of the segment were also different. The very fact that in the contract, the supply segment and service segment had been specified in different parts of the contract was a pointer to show that the liability of the taxpayer thereunder would also be different.

Merely signing of contract in India will not make the entire contract taxable in India

The contract indisputably was executed in India. By entering into a contract in India, although parts thereof would have to be carried out outside India, that would not make the entire income derived by the contractor to be taxable in India.

Doctrine of territorial nexus applied

According to the Supreme Court, territorial nexus doctrine played an important part in assessment of tax. Income arising out of operation in more than one jurisdiction would have territorial nexus with each of the jurisdiction on actual basis. If that be so, it would not be correct to contend that the entire income 'accrues or arises' in each of the jurisdiction.

PE is not involved in the activities

In the present case, the PE had no role to play in the transaction that was sought to be taxed, since the transaction took place abroad. All the income arising out of the turnkey project would not be assessable in India, only because the taxpayer had a PE. The distinction between the existence of a business connection and the income accruing or arising out of such business connection is clear and explicit. In the present case, the PE's noninvolvement in the transaction excluded it from being a part of the cause of the income itself, and thus there was no business connection. The concept of business connection and PE should not be mixed up. Business connection is relevant for the purpose of application of Section 9 and the concept of PE is relevant for assessing the income of a non-resident under the Tax Treaty.

In the present case, the entire transaction was completed on the high seas, therefore, income from the transaction did not arise in India. Having been excluded from the scope of taxation under the Act, the application of the Tax Treaty would not arise. The taxpayer took recourse to the Tax Treaty only by way of an alternate submission on income from services and not in relation to the tax of offshore supply of goods. The provisions of Article 7 of the Tax Treaty would be applicable, as services rendered outside India would have nothing to do with PE in India. Thus, if any services were rendered by the head office of the taxpayer outside India, only because they were connected with PE, the principle of apportionment shall not apply. The AAR committed an error by treating the services rendered by the head office as services rendered by the PE. This would obliterate the distinction between Indian and foreign operations and the apportionment of the income of the operations.

Services are provided/ used in India but not rendered in India

In order to tax the income of a non-resident under section 9(1)(vii)(c) of the Act, two conditions should be fulfilled namely : services, which are source of income sought to be taxed in India must be utilized in India and rendered in India. In the present case, both these conditions were not satisfied simultaneously. Section 9(1)(vii) of the Act must be read with Section 5 thereof, which takes within its purview the territorial nexus on the basis whereof tax is required to be levied, namely, resident and receipt or accrual of income. Whatever is payable by a resident to a non-resident by way of fees for technical services would not always come within the purview of Section 9(1)(vii) of the Act. It must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax.

With respect to taxability of income from offshore supply, the Supreme Court laid down as under:

- Since all parts of the transaction, i.e. the transfer of property in goods as well as the payment, were carried on outside India, the transaction could not be taxed in India.
- The principle of apportionment, wherein the territorial jurisdiction of a particular state determines its capacity to tax an event, has to be followed.
- The fact that the contract was signed in India was not relevant, since all activities in connection with the offshore supply were outside India, and therefore could not be deemed to accrue or arise in India.

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- There exists a distinction between a business connection and a PE. The PE cannot be equated to a business connection, since the former is for the purpose of assessment of income of a non-resident under a Tax Treaty and the latter is for the application of section 9 of the Act.
- The existence of a PE would not constitute sufficient 'business connection', and the PE would be the taxable entity. The fiscal jurisdiction of a country would not extend to taxing the entire income attributable to the PE.
- There exists a difference between the existence of a business connection and the income accruing or arising out of such business connection.

With respect to taxability of income received from offshore services, the Supreme Court laid down as under:

- Sufficient territorial nexus between the performance of services and territorial limits of India was necessary to make the income taxable.
- For Section 9(1)(vii) to be applicable, it was necessary that the services not only be utilized within India, but also be rendered in India or have such a "live link" with India that the entire income from fees as envisaged in Article 12 of Tax Treaty becomes taxable in India.
- The terms 'effectively connected' and 'attributable to' were to be construed differently even if the offshore services and the PE were connected.
- Section 9(1)(vii)(c) of the Act would not apply since there was nothing to show that the income derived by a non-resident company irrespective of where service was rendered, was utilized in India.
- Article 7 of the Tax Treaty was applicable in the present case and it limited the tax on business profits to that arising from the operations of the PE. The entire services were rendered outside India and were not connected with the PE. Thus, no income was attributable to the PE and was not taxable in India.
- If the test applied by the AAR was to be adopted here too, then it would eliminate the difference between the connection between Indian and foreign operations, and the apportionment of income accordingly.
- The services were inextricably linked to the supply of goods, and it must be considered in the same manner.

34. DIT v. Morgan Stanley & Co. INC [2007] 292 ITR 416 (SC)

The taxpayer, Morgan Stanley & Co incorporated in USA, is a leading investment bank engaged in the business of providing financial advisory services, corporate lending and securities underwriting services. Morgan Stanley Advantage Services Private Limited (MSAS) was a group company set up in India to provide certain support services to the taxpayer. The taxpayer entered into an agreement with MSAS to support the main office functions in equity and fixed income research and to provide IT enabled services such as back office operation, data processing and support centre to the taxpayer.

The taxpayer had proposed to send its employees to India to acquaint MSAS with the global standards and requirements of services expected of MSAS to meet the global benchmarks of the Morgan Stanley group. The taxpayer also planned to send staff on deputation to MSAS at the latter's request. The employees would remain on the payroll of the taxpayer and the actual cost (without profit element) of these employees was to be reimbursed by MSAS to the taxpayer. The taxpayer paid MSAS costs (both direct and indirect) plus a mark up (29 percent) based on a transfer pricing study using the Transactional Net Margin Method (TNMM) for the services rendered by MSAS.

The taxpayer sought a ruling from the AAR on the issue of whether MSAS would constitute a Permanent Establishment (PE) of the taxpayer in India, having regard to the provisions of Article 5(1)⁸ of the India-USA

Tax Treaty (Tax Treaty) and if so what would be the amount of income attributable to such PE.

The AAR held that the taxpayer did not have a 'fixed place' PE in India as per Article 5(1) of the Tax Treaty. Further, MSAS could not be regarded as an agency PE under Article 5(4)⁹ of the Tax Treaty. However, the taxpayer

⁸ Article 5(1) of the DTAA defines a PE to mean a fixed place of business through which the business of the enterprise is wholly or partly carried on.

⁹ Article 5(4) of the Tax Treaty provides that a person acting on behalf of the enterprise of the other Contracting State will be deemed to be a PE if (a) he habitually concludes contracts on behalf of the enterprise unless the activities are 'excluded activities' as defined in Article 5(3) like preparatory and auxiliary activities; (b) he has no authority but habitually maintains a stock of goods for delivery; (c) habitually secures orders wholly or almost wholly for the enterprise.

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would be regarded as having a service PE in India under Article 5(2)(l)¹⁰ as it proposed to send its employees to India for undertaking stewardship activities or on deputation in the employment of MSAS.

However, as MSAS was remunerated at an arm's-length, no further income could be attributable to the taxpayer's Indian PE.

Issues before the Supreme Court

- Whether the taxpayer has a PE in India?
- Whether after making payment at ALP, any further income was attributable to the taxpayer's PE, if any?

Supreme Court's Decision

No fixed PE

The Supreme Court observed that MSAS was engaged in supporting the front office functions and in providing IT enabled services to the taxpayer. The Supreme Court held that one had to undertake a functional and factual analysis of each of the activities to be undertaken by an establishment in order to decide whether there was a PE or not. MSAS was performing only back office operations in India. Accordingly, MSAS did not constitute a fixed place PE as regards its back office functions.

No Agency PE

As per Article 5(4) of the Tax Treaty, a person acting on behalf of the enterprise constitutes an agency PE if he habitually concludes contracts on behalf of the enterprise. In the present case, MSAS has no authority to enter into or conclude contracts as contracts would be entered into and concluded in USA. The implementation of those contracts only to the extent of back office functions would be carried out in India; therefore, MSAS would not constitute an Agency PE.

The Supreme Court also observed that there was an inclusive definition of

¹⁰ Article 5(2)(l) provides that the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel but only if: (i) activities of that nature continue within that State for a period or periods aggregating to more than 90 days within any twelve month period; or (ii) the services are performed within that State for a related enterprise [within the meaning of paragraph 1 of article 9 (associated enterprises)] would constitute a PE.

PE under the Act whereas the Tax Treaty provides an exhaustive definition of the same.

Deputation of personnel created PE in India, however; stewardship functions do not result into a PE

Stewardship activities involved briefing the staff of MSAS to ensure that the output of MSAS met the requirements of the taxpayer. According to the Supreme Court, the stewards were not involved in the day to day management or in any specific services to be undertaken by MSAS. The stewardship activity was basically to protect the interest of the taxpayer. It could not be said that the taxpayer was rendering services to MSAS. In fact, the taxpayer was merely protecting its own interest. In view of above, the Supreme Court held that stewardship activity did not fall under service PE and it disregarded the AAR ruling to that extent.

With regard to deputation, the Supreme Court held that when an employee of the taxpayer was deputed to MSAS, it did not become an employee of MSAS. A deputationist had a lien on his employment with the taxpayer. With respect to service PE, the Supreme Court was of the view that where the activities of the taxpayer made it responsible for the work of deputationists and the employees continued to be on the payroll of the taxpayer or they continued to have their lien on their jobs with the taxpayer, a service PE could emerge. In the instant case, the taxpayer deputed staff on the request of MSAS. The deputationist lent his experience to MSAS in India as an employee of the taxpayer as he retained his lien. Accordingly, the Supreme Court held that employees who are on long term deputation to MSAS constituted service PE of the taxpayer under Article 5(2)(i) and upheld the AAR ruling to that extent.

Attribution of profits to PE

The Supreme Court has noted that the PE has to be treated as an independent enterprise dealing with the head office at an arm's-length and its profits are to be determined on such basis. The Supreme Court observed that the remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to the PE. The Supreme Court, therefore upheld the AAR's finding, in principle insofar as an associated enterprise (that also constitutes a PE) was remunerated on an arm's-length basis taking into account all the risk-taking functions of the enterprise there should be no additional profits attributable in India.

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It was further observed that the situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be need to attribute profits to the PE for those functions/risks that have not been considered.

Attribution of Profits to PE – other observations

The Supreme Court held that TNMM was the most appropriate method in the case of service PE as TNMM apportions the total operating profit arising from the transaction on the basis of sales, costs, assets, etc.

The Supreme Court held that the computation of the remuneration based on cost plus mark up, which worked out to 29 percent on the operating costs of MSAS, was correct.

35. Leonhardt Andra Und Partner, GMBH v. CIT [2001] 249 ITR 418 (Cal.)

This case pertains to assessment year 1981-82. The taxpayer, a German company entered into a design contract in 1974 with HRBC, a statutory authority created by the State of West Bengal. This contract came to an end in 1978 and a new agreement was entered into between the taxpayer and HRBC in 1980. The taxpayer filed a 'nil' return for the assessment year in question, claiming that it did not have a PE in India. It also contended that the only income it earned was by way of fees for technical services within the meaning of Section 9(1)(vii) of the Act and these fees were payable in pursuance of the agreement entered into and approved by the Central Government before 1 April 1976. Hence, the fees were not chargeable to tax as per the proviso to Explanation 1 to section 9(1)(vii) of the Act.

The proviso to Section 9(1)(vii) of the Act exempts income by way of royalty or by way of fees for technical services payable in pursuance of an agreement made before 1 April, 1976 and approved by the Central Government. The AO was of the view that the new design contract dated 18 April 1980 was a new agreement entered into after April 1976. Therefore the amount payable to the taxpayer for services rendered under the contract were taxable under the provisions of Sections 9(1)(vi) and 9(1)(vii) of the Act. He did not accept the taxpayers contention that these amounts were not taxable in view of the DTAA between India and the Federal German Republic (as it stood prior to its amendment in 1984).

The CIT (A) upheld the view of the AO that the amounts remitted to the taxpayer were in the nature of royalty and hence taxable. The Tribunal too affirmed the order of the AO and held that it was an altogether new agreement.

The High Court held that it was evident from the contract that the agreement had been entered into after a gap of two years without any indication in it that it was a continuation of the earlier agreement in 1974. On a consideration of the facts and circumstances of the case, it was held that the remittances received pursuant to the agreement of 1980 were taxable in India. [*Leonhardt Andra Und Partner, GMBH v. CIT (2001) 249 ITR 418 (Cal.)*]

The issue for consideration was whether on the facts and circumstances of the case and on a true interpretation of the DTAA between India and Germany, the transfer of drawings, designs and technical services under the collaboration agreement constituted an out and out transfer of such rights. Could the sums received by the taxpayer be treated as royalty for the purpose of the DTAA and hence be liable to Indian income tax.

The High Court observed that the term “royalty” was not defined in the DTAA (as it stood prior to its amendment in 1984), and it had also not been included within the term “industrial and commercial profits”. Hence, the definition of the term as given in the Income-tax Act would prevail. The Court also observed that the definition of royalty as given in several decisions completely agrees with the term of the agreement between the German company and HRBC.

It was held that the sums received by the taxpayer for design and technical services for the construction work were in the nature of royalty within the meaning of the term in Section 9(1)(vi) of the Act and hence were taxable. The fact that the taxpayer did not have a PE was of no relevance.

36. DDIT v. Tekmark Global Solutions LLC [2010] 131 TTJ 173 (Mum)

The taxpayer, a tax resident of USA, entered into an agreement with an Indian company for deputation of taxpayer’s personnel to the Indian company on hire out basis. As per the agreement, the personnel would work under the supervision and control of the Indian company. The deputed personnel would remain on the payroll of the taxpayer. The Indian company is allowed to send back the personnel to the taxpayer if it is not satisfied with the work or efficiency of the personnel.

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The taxpayer claimed that the amount received by it was not taxable in India since it does not have PE in India as per article 5(2) of the DTAA between India and USA. However, the AO held that the taxpayer rendered service to the Indian company through its deputed personnel and thus, it created PE in India as per article 5(2) of the DTAA between India and USA.

On appeal, the CIT(A) held that from the agreement it was clear that the taxpayer merely deputed its personnel and no services were provided to the Indian company. Accordingly, in the absence of PE of taxpayer in India, the consideration received by the taxpayer was not taxable as per the provisions of the DTAA between India and USA.

Aggrieved by the order of CIT(A), the department went on appeal before the Hon'ble Tribunal. Before the Tribunal the taxpayer contended that only the personnel were deputed to the Indian company and no services were provided. Therefore, Service PE was not created under the provisions of the DTAA. Accordingly, the taxpayer was not liable to pay any tax in India.

Tribunal, after hearing both the parties observed that the following:

- Taxpayer only deputed its personnel to the Indian company which will supervise and control such personnel. From the agreement, it is clear that such personnel were not provided to render any technical service to the Indian company.
- The deputed personnel were, for all practical purposes, employees of the Indian company and they carried out work allotted to them by the Indian company.
- The taxpayer was not having any control over the activities or the work to be performed by such personnel. Further, the Indian company had a right to remove the personnel from the services.

The amount received by the taxpayer from the Indian company was reimbursement of the cost incurred by the taxpayer on such personnel. When the services rendered by personnel were independent of and not under the control of the taxpayer, the deputed personnel cannot constitute PE of the taxpayer in India. Accordingly, Service PE was not created under the provisions of the DTAA. Hence, the amount received by the taxpayer was not taxable in India.

Further, the Tribunal observed that even if it is assumed that there is a PE in India, there is no profit accruing from the activities in India as the taxpayer

was paid only the actual salary paid by them in advance to the deputed personnel. The Tribunal also relied on certain judicial precedents wherein it was held that the income did not arise in the reimbursement of expenditure.

37. Cartier Shipping Co Ltd v. DDIT [2010-TII-65-ITAT-MUM-INTL]

The taxpayer, a company originally registered in Cyprus was later registered as a foreign company in Mauritius and was issued a tax residency certificate in Mauritius. The taxpayer owned a rig used for drilling, prospecting and production of hydrocarbons in the offshore oil fields. The rig was given for hire on charter basis to a Company. The income so earned by the taxpayer was offered to tax in India on net basis after claiming deduction of depreciation.

The taxpayer entered into an agreement to sell the rig to another non-resident due to which it moved the rig from Indian territorial waters to International waters and terminated the contract with the earlier Company. The taxpayer filed 'nil' return of income on the grounds that since business operations in India were discontinued and the taxpayer had sold the rig outside the territorial waters of India, profits from the sale of the rig was not taxable in India. However, AO held that the gain from the sale of a PE asset is taxable in India under the Act as well as under the DTAA.

Department argued that mere closure of the business of the taxpayer in India did not imply that the entire taxability had come to an end. The cessation of PE is relevant only for the purpose of business profits and has no impact on taxability of capital gains on the alienation of PE or its assets. All the process for finalizing the deal occurred in India. Just because the delivery is given outside India, it cannot be said that sale has taken place outside India. The sale had taken place as a part of winding up operations of the PE and therefore should be taxable in India. The taxpayer had claimed depreciation on the rig and hence accepted the fact that the rig is a part of its Indian PE hence the gain on sale of assets of the PE is taxable in India.

The taxpayer contented that the sale of the rig took place only on the day on which possession of rig was handed over to the buyer. The risk in the rig passed to the buyer only upon handing over the rig and thus it could not be said that the sale of the rig had taken prior to the date of delivery.

Once the rig itself moves out of Indian territorial waters, the taxpayer cannot be said to have a PE in India and in the absence of PE in India the income from sale of rig is not taxable in India.

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The matter came before the Tribunal. The Tribunal relied on the decision of the Supreme Court in the case of *Hyundai Heavy Industries Limited* wherein it was held that ascertainment of a foreign enterprise's taxable business profits in India involves an artificial division between profits earned in India and profits earned outside India. This demarcation is necessary in order to earmark the tax jurisdiction over the operations of a company. Thus on sale of Indian PE's assets, the gains accruing thereon, are taxable in India.

- The Tribunal observed that when a PE ceases to exist, either there can be a transfer of asset back to the non-resident or there can be an alienation of such an asset to an outsider. There cannot be any gains on transfer of assets back to the non-resident, as no consideration is attached to such a transfer. However, when PE assets are being alienated to an outsider, the gains or losses on such alienations are to be treated as gains or losses to the PE with consequent tax implications.
- It is immaterial whether the assets were sold in or outside India. It is a factual position that the rig was an asset of a PE in India and, hence, even if sales had taken place as part of the winding up process of the PE, it would still be taxable in India. The continuity of business operations through the PE is relevant only for the purposes of taxability of business profits in the source country and for no other purposes.
- If capital gain on alienation of PE's moveable assets is taxed in the source country only when PE exists, the taxability of gains on PE assets in the source country would be rendered redundant. In those cases the taxpayer may simply defer the receipt of sale consideration or defer the sale transaction itself to avoid the tax liability on such an alienation of assets.
- Article 13(2) of the DTAA seeks to tax gains on alienation of such assets in the tax jurisdiction in which PE or fixed base is situated. Therefore, the situs of taxability profits on alienation of assets is the same as the situs of taxability of income from such assets. It is thus clear that the profits on sale of the rig are also taxable in India

38. ACIT v. Epcos AG, Germany [2009] 120 TTJ 29 (Pune)

The taxpayer was a German company engaged in the business of designing, manufacturing and marketing electronic components. It had subsidiaries

across the world including two subsidiaries in India. In the relevant year, the subsidiaries had paid fees to the taxpayer in respect of royalty, product marketing services, information and technology support services, interest on External Commercial Borrowings (ECB) and sales support. The marketing functions were centralised at the headquarters in Germany. The central marketing team rendered services for the benefit of various manufacturing companies in that division all over the world, and a fee was charged by the taxpayer for those services. The information and technology support services rendered by the taxpayer, for which these costs were recovered, included costs such as lease rental of physical lines and hardware like routers, switches, licenses for MS Office and other software such as Oracle for servers, development and maintenance of central SAP system etc. The sales support services were in the nature of services for identifying the customers, consultations, working out time schedules, negotiating price terms, fixing delivery schedule, negotiating credit terms, assuring payments, taking care of currency and exchange rates, supply of technical information, attending to customer complaints and organisation of rework.

The Transfer Pricing Officer accepted the transaction values disclosed by the taxpayer as an Arm's Length Price, without making any adjustments. The taxpayer had offered to tax in India, the consideration in respect of the above services, by applying 10 percent on gross basis as royalty/FTS under Article 12 of the DTAA.

The AO held that the taxpayer had a PE in India, in the form of its subsidiaries, since the taxpayer was conducting its business in India through its subsidiaries and more specifically through employees of the subsidiaries. Accordingly, the AO held that the income earned by the taxpayer were taxable in India at the rate of 20 percent under Section 44D read with Section 115A of the Act.

The CIT(A), after analyzing the e-mails and correspondence exchanged by the taxpayer with its subsidiaries in India, held that these were routine mails and correspondence which deal with a very limited aspect of business of the Indian subsidiaries. The CIT (A) also noted that the taxpayer company had no employees in India and, therefore, the AO's claim that the taxpayer had a place of management in India, was not correct. The CIT(A) further held that merely because the taxpayer had a subsidiary company, it could not be concluded that the taxpayer had a PE in India.

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The issue came before the Tribunal which held that;

- The taxpayer had received payments for support services and not for the functions of the subsidiaries. The payment which was made to the taxpayer was only for the services rendered by the taxpayer company, either directly through its own employees in Germany or through a third party. The payment consisted of reimbursement of costs plus a mark-up thereon for the indirect overheads. Further, there was no reimbursement of costs incurred on any of the employees in India and, therefore, there was no payment on account of the services rendered by any India based employee. Accordingly, no income was earned by way of any employee in India.
- The taxability under Article 12 of the DTAA shifts to taxability under Article 7 only in respect of 'royalties' and 'FTS' which were attributable to the PE. Since the taxpayer received 'royalties' and 'FTS' but these receipts did not have an effective nexus with the Indian subsidiaries, therefore, no part of the income earned by the taxpayer was attributable to the PE.
- The taxpayer did not have any PE in India to which subject 'royalties' and 'FTS' could be attributed. Therefore, India did not have right to tax these receipts as business profits under Article 7 of the DTAA but it was taxable at the rate of 10 percent on gross basis under Article 12 of the DTAA.
- Merely because the Indian subsidiaries conducted its business, with the help and guidance it had received from the taxpayer, in India, it did not follow that the taxpayer would be deemed to have a PE in the form of that domestic company. The e-mails and letters were sent from outside India, and at best Indian subsidiaries acted upon the advices so given in the e-mails and letters in India. However, the action of the subsidiaries cannot alter the situs of the activities of the taxpayer.
- The DTAA is not an exemption regime, it is an alternative tax regime. The provisions of the DTAA override, therefore, it needs to be examined first before observing the domestic tax laws in relation to taxability of the non-resident covered by the DTAA. If the royalties and FTS were so included in the business profits attributable to the PE only then section 44D and 115A could be invoked. Therefore, even if the taxpayer had a PE in India, unless it was established that the

receipts were attributable to that PE, such receipts of the taxpayer sourced from India would not have been taxable in India under Article 7 of the DTAA. The provisions of section 44D and Section 115A do not, come into play merely because there was a PE in India.

39. K.T. Corporation v. DIT [2009] 181 Taxman 94 (AAR)

The taxpayer, a company incorporated in Korea was in the business of telecommunication carrier/reseller. The taxpayer set up a Liaison Office (LO) in India with the permission of Reserve Bank Of India (RBI) to act as a communication channel between the Head Office (HO) of the taxpayer and the concerned parties i.e. Indian companies, within the parameters listed out by the RBI. The LO was also involved in the following activities:

- (i) organizing seminars, conferences
- (ii) receiving trade enquiries from the customers
- (iii) advertising for the taxpayer
- (iv) collecting feedback from the prospective customers/consumers, trade organizations etc. and has neither played any role in the pre-bid survey etc.

Pursuant to the opening of the LO, the taxpayer entered into a Reciprocal Carrier Service Agreement (RCSA) with Vodafone Essar South Ltd. (VESL) to interconnect and to provide certain services to each other. In respect of each service, the parties were required to raise invoices during each calendar month and the invoiced party will make payments to the invoicing party.

Issue which came before the AAR was whether the LO can constitute a PE of the taxpayer under the DTAA between India and Korea ?

AAR held as follows:

- The expression PE means a 'fixed place of business' through which the business of a foreign enterprise was wholly or partly carried on in another contracting state. The activities listed in Para 4 of Article 5 of the DTAA were exceptions to the basic concept of PE and are considered as preparatory or auxiliary vis-à-vis the main business activity of the foreign entity.
- As per statutory provisions, the activities of a LO were restricted and it

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could not legally secure orders from the customers in any manner either directly or indirectly. The LO may be a fixed place and the activities conducted by it may be a business activities but these are restricted to preparatory or auxiliary activities only.

- As per article 5(4)(e) of the DTAA and OECD commentary a fixed place of business through which the LO exercises preparatory or auxiliary activity for the HO was deemed not to be a PE.
- The LO did not break the parameters prescribed by the RBI and the RBI extended the LO status since the activities undertaken by the LO were in the nature of preparatory and auxiliary in nature. Thus, the services and work performed by the LO were in the nature of preparatory and auxiliary activities and therefore, in terms of the DTAA the LO did not constitute PE.
- If the activities of the LO goes beyond the parameters fixed by RBI or if the department finds any concrete materials which substantially impact on the veracity of the taxpayer's version of facts, it is open to the department to take appropriate steps under law.

The matter came before the Tribunal which held :

- As per Section 5(2) of the Act, the income of a non-resident person arises or accrues or deemed to arise or accrues in India if it has business connection in India in respect of its source income.
- The LO was in continuation of the trading activities of the taxpayer and therefore, it constitutes business connection in respect of source of income in India and hence, the income of LO will be taxable in India.
- As per the DTAA, the business profits of the non-resident taxpayer will be taxable if it has a PE in India. The business of the taxpayer was partly carried on by the LO. Therefore, the office of the LO cannot be excluded from the word 'office' as contained in article 5(2) of the DTAA between India and Korea.
- As per the article 5 of the DTAA if a taxpayer maintains a fixed place of business solely for the purpose of advertising, supply of information, scientific research or any other activity which has a preparatory or auxiliary character in the trade or business of the enterprise will not be considered as PE.

- The LO was having a freedom to fix the sale price and to conclude the contract, and such contract cannot be termed as a preparatory or auxiliary character.

Therefore, the Tribunal held that it cannot be said that the LO was solely for the purpose of supply of information or doing a preparatory or auxiliary character in the trade or business. Accordingly, the Tribunal held that business of the taxpayer was partly carried on by the LO and hence, it will constitute PE as per the article 5 of the DTAA.

40. DDIT v. Clough Projects International Pvt Ltd. (2010-TII-55-ITAT-MUM-INTL)

The taxpayer, an Australian company, entered into an agreement with an Indian company on 5 November 2004 for carrying out engineering, procurement, installation and commissioning services of three wellhead platforms and modifications to existing platforms in certain Oil fields in India. The taxpayer received consideration on 15 February 2005 on account of lump sum payment.

For Assessment Year (AY) 2005-06, the taxpayer filed a tax return declaring nil income on the grounds that as per the provisions of the DTAA, the taxpayer did not have PE in India and therefore, its business profits were not taxable in India.

However, the AO held that since the taxpayer was exclusively dealing with the commissioning of new platform for oil wells, as per Article 5(2)(f) of the DTAA between India and Australia, the taxpayer formed PE in India. Accordingly, the AO estimated the income of the taxpayer at the rate of 10 percent of the gross receipts in terms of Section 44BB(2) of the Act.

The taxpayer contended that Article 5(2)(f) of the DTAA between India and Australia would apply to a person actually operating the mine, oil or gas well, etc. However, the work performed and to be performed by the taxpayer was in the nature of an installation project and therefore, the Article 5(2)(k) of the DTAA between India and Australia dealing with construction PE would be applicable instead of Article 5(2)(f) of the DTAA between India and Australia.

Further, for AY 2005-06, the taxpayer did only limited work like contracting with the sub-contractor, identifying the vendor for the purpose of procurement of necessary materials and equipments, etc. and did not work on the site.

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CIT(A)'s Ruling

- CIT(A) observed that the taxpayer was an engineering company and not a natural resource company. Further, the appellant has no right over the gas or oil well which was belonging to an Indian company. Accordingly, the CIT(A) held that the taxpayer was not covered by Article 5(2)(f) of the DTAA between India and Australia.
- Since the taxpayer entered into a contract with an Indian company for installing and commissioning three well head platform and modifications of existing platforms, its case was covered by Article 5(2)(k) of the DTAA between India and Australia. However, since the taxpayer entered into an agreement on 5 November 2004, the taxpayer did not complete six months during the AY 2005-06. Therefore, taxpayer did not create PE in India in terms of Article 5(2)(k) of the DTAA between India and Australia.
- Further, during the year under consideration, the work performed by the taxpayer was limited to placing orders for the offshore supply of steel and fabrication outside India and delivery of steel commenced on 30 April 2005.
- Accordingly, the CIT(A), after applying the decisions of Supreme Court in the case of Ishikawajima Harima Heavy Industries Co. Ltd¹¹ and Hyundai Heavy Industries Co. Ltd¹², held that an installation PE will commence when the supply of steel arrives at the oil well site, which falls in the next financial year.

Tribunal's ruling

The Tribunal while upholding the order of the CIT(A) and after relying on the decision of the AAR in the case of Brown and Root Inc. held that since an installation project was not carried on for more than six months, as per Article 5(2)(k) of the DTAA between India and Australia the taxpayer did not create PE in India.

41. ITO v. Right Florists Pvt Ltd (ITA No.1336/Kol/2011)

The taxpayer, a florist, had made payments in respect of online advertisements to Google and Yahoo without deducting taxes on the basis

¹¹ Ishikawajima Harima Heavy Industries Co. Ltd. v. DIT [2007]288 ITR 408 (SC)

¹² CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC)

that since these entities did not have any PE in India, the payment made to them was not taxable in India.

The AO disallowed the payments in the hands of the taxpayer under Section 40(a)(i) of the Act on the basis that tax was required to be deducted from the payments made to Google and Yahoo.

The issue for consideration before the Kolkata Tribunal was whether the payment in respect of online advertising on search engines of Google and Yahoo is taxable in India.

Based on the facts of the case, the Tribunal, inter alia, observed and held as follows:

- A search engine's presence in a location, other than the location of its effective place of management, is only on the internet or by way of its website, which is not a physical form of presence;
- In accordance with the High Power Committee report, so far as the basic rule of PE is concerned, a website per se cannot be a PE under the Act;
- The interpretation of the expression PE, even in the context of tax treaties, does not normally extend to websites unless the servers on which websites are hosted are also located in the same jurisdiction;
- A search engine, which has only its presence through its website, cannot be treated as a PE unless its web servers are also located in the same jurisdiction. As Yahoo and Google's servers are not located in India, its presence in India merely through websites cannot be construed as PE in India;
- The Government of India's reservations on OECD (relating to websites constituting a PE in certain circumstances) does not have an impact in the instant case;
- Relying on the decisions of the Mumbai Tribunal in the case of Pinstorm Technologies Pvt. Ltd. and Yahoo India Pvt. Ltd, the Tribunal held that the payments to Google and Yahoo are not in the nature of 'Royalty';
- As long as there is no human intervention in a technical service, it cannot be treated as a technical service under Section 9(1)(vii) of the Act. As there was no human touch involved in the whole process of the

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advertising service provided by Google and Yahoo, the payments are not in the nature of 'fees for technical services';

Therefore, the payments were not taxable in India and there was no requirement for the taxpayer to deduct tax at source.

42. DDIT v. Western Union Financial Services Inc [2012] 50 SOT 109 (Del)

The taxpayer, a company incorporated in USA, is engaged in money transfer business world-wide. For enabling transfer of money to beneficiaries in India, the taxpayer entered into agreements with the agents i.e. Department of Posts, commercial banks, non-banking financial companies and tour operators. The taxpayer had opened, with the approval of RBI, Liaison offices (LO) in India. The AO held that LOs were a virtual projection of head office in India and thus constituted taxpayer's PE in India. The taxpayer had a full-fledged office in India which was conducting aggressive marketing activities together with negotiations with the agents, providing software to them and imparting training about the product. There was continuity of the transaction which was completed only when the money was paid the beneficiary in India. Accordingly, there was 'business connection' in India and the taxpayer was liable under Section 9(1) of the Act to pay income-tax on the profits arising from its activities in India. The CIT(A) held that the taxpayer had a business connection for all the relevant assessment years but did not have a PE in India.

Tribunal's ruling

- The Tribunal relied on the earlier Tribunal decision in the taxpayer's own case where it was held that since There was business connection and hence the taxpayer was liable to tax under Section 9(1) of the Act; but since there was no PE in India under Article 5 of the tax treaty between India and the USA, no profits could be attributed to the Indian operations of the taxpayer and taxed in India.
- Accordingly, relying on the earlier decision in the taxpayer's own case the Tribunal held that the liaison offices did not constitute PE of the taxpayer.

43. Delmas, France v. ADIT [2012] 49 SOT 719 (Mum)

The taxpayer is a foreign company engaged in the business of operations of ships in international traffic. The taxpayer claimed that it does not have any

PE in India and hence, the business profits earned could not be taxed under Article 7 of the tax treaty. The AO rejected both claims of the taxpayer on non-taxability and noted that the taxpayer carried out the business from a fixed place through an agent in India. The AO held that the taxpayer had a PE in India and in the absence of details to compute profits of the PE, he adopted total income at the rate of 10 percent of gross receipts. The Dispute Resolution Panel (DRP) held upheld the order of the AO.

Tribunal's ruling

The Agency PE provisions provided in the tax treaty specifically override the fixed base PE provisions provided in the tax treaty. In as much as if a foreign enterprise is carrying on business in the other contracting state through an agent, the fixed base PE provisions provided in the tax treaty do not come into play.

In view of the Bombay High Court's decision in the case of Set Satellite (Singapore) Pte Ltd¹³, the controversy regarding existence of PE could perhaps be a wholly academic issue in as much as once the agent is paid an arm's length remuneration for the services rendered, no further profits can be attributed to the PE.

In case of Agency PE, the subjective criterion, i.e. 'right to use that place', can never be satisfied in as much as it is a sine qua non of a fixed base PE as against the 'business agency model' wherein business of the foreign enterprise is carried on by the agent and the foreign principal does not have the powers, as a matter of right, to use the said place for carrying on its business.

The use of physical location in case of Agency PE is always by the agent, though it is for furtherance of business interests of the principal. Therefore, in the instant case the subjective criterion for the existence of a PE is not satisfied and the PE under the basic rule cannot be said to have come into existence. Accordingly, the taxpayer could not be said to have a PE under the basic rule, as the taxpayer was doing business through agent and business of the taxpayer is carried out from the premises owned by the agent.

The significant feature of DAPE of the tax treaty is somewhat unique in the sense that this provision is in clear deviation from the standard UN and

¹³ Set Satellite (Singapore) Pte Ltd. v. DDIT [2008] 307 ITR 205 (Bom)

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OECD Model conventions. Even when an agent is wholly or almost wholly dependent on the foreign enterprise, he will still be treated as an independent agent unless additional condition of the transactions being not an arm's length conditions is fulfilled.

The DAPE provisions of the tax treaty are not applicable in case the business is carried out by the foreign enterprise through an independent agent because Article 5(5) of the tax treaty specifically excluded independent agent from its ambit. Therefore, as long as the agent is of independent status, the provisions of Article 5(5) of the tax treaty could not be invoked.

The onus of establishing that there is a PE is on the tax department and there is no room for inferences being drawn up in this respect merely because the taxpayer has made a particular claim. Similarly, reference to agent's authority to conclude contracts, as has been made by the DRP is not decisive test either because even when agent has the authority to conclude contracts, it is still to be established that the agent is not an independent agent. That exercise is not even conducted in this case.

These conclusions are arrived at in the light of the factual position that there are no findings by the AO, or DRP, to the effect that the transactions between the agent and the taxpayer are not at an arm's length price and in view of the provisions of Article 5(6) of tax treaty, such a finding by the tax department is a sine qua non for existence of DAPE.

This case has been affirmed by the Bombay High Court in the case of **DIT vs. Delmas France (2015) 281 CTR 265 (Bombay)**.

44. Aramex International Logistics Private Limited [2012] 348 ITR 159 (AAR)

The Aramex Group is engaged in the business of door-to-door express shipments by air and land and performing related transport services. It has the expertise, experience, personnel, technical information and know-how required for the said business. The applicant is a company incorporated and tax resident of Singapore forming part of the Aramex Group. The applicant entered into an Agreement dated 1 April 2010 (the Agreement) with AIPL for non-exclusive services surrounding the movement of packages to and from India i.e. Inbound and outbound. This business arrangement was originally between AIPL and Aramex International Limited, Bermuda.

As per the Agreement, in respect of outbound consignments, AIPL picks up the consignments from the respective consignors in India, gets them

delivered to a destination outside India. On such consignments reaching the overseas destination, the applicant arranges to get them cleared and ensures delivery to the ultimate consignee. In respect of inbound consignments, the role played by the applicant in outbound transaction is carried out by AIPL and role played by AIPL is carried out by the applicant.

The Agreement is on principal-to-principal basis and AIPL is otherwise neither authorised, nor can act on behalf of, or legally bind the applicant. Neither the applicant nor AIPL are liable to each other for negligence or misrepresentation or otherwise for loss of profits or revenues in business, anticipated savings and so on.

AIPL was entitled to appoint and use another transportation and logistics service provider outside the Aramex Group upon request by the customer. The applicant was also charging fees to AIPL for providing support functions such as invoicing and payments. There were also separate agreements covering payment of 'royalty' and 'fees for technical services' by AIPL which were not the subject matter of the application to the AAR.

Issues before the AAR

- Whether there is a PE of the applicant in India under the India-Singapore tax treaty (tax treaty)?
- If the applicant constitutes a PE in India as above then whether receipts by the applicant from outbound and inbound consignments are attributable to the said PE in India?
- Without prejudice, if the transactions between the applicant and AIPL are on arms length basis, whether any further income can still be attributed to the said PE?
- Whether the fees received by the applicant from AIPL for the support functions are in the nature of 'fees for technical services' under the tax treaty?
- Whether the payments made by AIPL to the applicant are subject to withholding of tax under Section 195 of the Act?

AAR ruling

- Aramex Group has admittedly business in various countries all over the world including India. Its business in India is conducted by it through AIPL which no doubt formed as a separate subsidiary but the

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fact remains that the business is that of the Aramex Group and the reputation and appealability is that of the Aramex Group.

- In entering of business for acceptance and deliveries of articles around the world, without the association of AIPL, the business of the Aramex Group as regards the Articles send to India cannot be performed.
- PE is defined to mean place of business which enables a non-resident to carry on a part of its whole business in particular country.
- This presence in India can be achieved through an independent entity or through a subsidiary. If the entity is an independent entity and uncontrolled by the Group, then there is no PE unless the requirements in Article 5(2) of the tax treaty are satisfied. In a case where a 100 percent subsidiary is created for the purpose of attending to the business of the group in a particular country, here, in India, the Indian subsidiary must be taken to be the PE of the Group in India.
- Even if AIPL has an independent existence, the authority over it of the principal, vertical or persuasive, cannot be in doubt.
- AIPL has a fixed place of business and branches in India and business of the applicant Aramex Group is being carried on by AIPL i.e. obtaining order, collecting articles and transports them to a destination so as to be taken over and delivered by the Group. Thus, AIPL is a Fixed Place PE of the applicant Aramex Group in India under Article 5(1) of the tax treaty.
- AIPL secures orders in India wholly for the Aramex Group and has right to conclude contracts for the group for its Express shipment business. Hence, AIPL is also an Agency PE of the Aramex Group under Article 5(8) of the tax treaty. Reliance was placed on a past Advance Ruling in AAR. No. 542 of 2001¹⁴.
- The exception with respect to control over Subsidiary not constituting a PE as per Article 5(10) of the tax treaty is not applicable as the whole business in India of the multinational group is carried on within the geographical contours of India. Further, mere description of AIPL as an independent entity or non-exclusive agent is not good enough and

¹⁴ Indian J.V. Co., In re [2005] 274 ITR 501 (AAR)

also the tax department's stand of the arrangement being a camouflage has considerable force.

- The AAR thus held as under:
 - AIPL is a PE of the applicant in India under Article 5 of the tax treaty;
 - The receipt from outbound and inbound consignments attributable to the PE in India is liable to tax in India;
 - The aspect about the transaction being at arm's length basis price has to be verified to determine whether any income can still be attributed to the PE in India.
 - Pursuant to above, the issue of taxation of payments for support services by AIPL to the applicant is declined.
 - The receipts by the applicant from AIPL would be subject to withholding of tax under Section 195 of the Act.

45. DDIT v. B4U International Holdings Ltd. [2015] 57 taxmann.com 146 (Bom)

The taxpayer, a Mauritius company having the Tax Residency Certificate (TRC), is engaged in the business of telecasting of TV channels such as B4U Music, MCM, etc. The taxpayer's revenue from India includes collections from time slots given to advertisers in India. The Indian companies namely B4U Multimedia International Ltd and B4U Broadband Ltd (collectively referred as 'B4U India'), were granted general permission by the Reserve Bank of India (RBI) to act as advertisement collecting agents of the taxpayer.

The taxpayer claimed that since it does not have PE in India, it is not liable to tax under the tax treaty. Further, agents' remuneration at Arm's Length Price (ALP) extinguishes the tax liability. However, the Assessing Officer (AO) held that the taxpayer has a PE in India in the form of B4U India and the payment of arm's length remuneration does not extinguish the tax liability of the taxpayer in India.

The Commissioner of Income-tax Appeals [CIT(A)] held that the taxpayer carries out its entire activities from Mauritius and all the contracts were concluded in Mauritius. The only activity carried out in India is incidental or auxiliary/ preparatory in nature which was carried out in a routine manner as per the direction of the principals without application of mind and therefore, it

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could not be treated as a DAPE in India. Further, since the agent was not a dependent agent and payment was made at ALP, no further profits could be attributed in India.

The Tribunal is held as follows:

- The entire issue as to whether the taxpayer has a PE in India or not, depends on the Agreement entered into between both the parties and the functions performed by them. On a plain reading of the agreement it indicates that agents are not the decision makers and it did not have authority to conclude contracts. The agents have no authority to fix the rate or to accept an advertisement. It can merely forward the advertisement and the taxpayer has the right to reject. The agent is an independent contractor and is not a servant or employee of the taxpayer. The tax department has not brought anything on record to show that the agents have power to conclude contract.
- The term 'has' used under Article 5(4) of the tax treaty vis-à-vis authority to conclude contract, has reference to legal existence of such authority in terms of the contract between principal and agent. A reading of the agreement shows that such power is not conferred on the agent. Similarly, the words 'habitually exercises' has reference to a systematic course of conduct on part of the agent, as held by the AAR in the case of TVM Ltd.¹⁵ In the present case, there is neither legal existence of such authority, nor is there any evidence to prove that the agent has habitually exercised such authority. When the agent has no authority to conclude contracts, the tax department cannot ask for contrary evidence as nobody can prove the negative. Thus, it was held that Article 5(4) of the tax treaty is not attracted in the instant case.
- Under Article 5(5) of the tax treaty, the wordings 'when the activities of such an agent are devoted exclusively or almost exclusively on behalf of the enterprises', refer to the activities of an agent and its devotion to the non-resident and not the other way round. The perspective should be from the angle of the agent and not of the non-resident. This view is contrary to the decision of the Tribunal in the case of DHL Operations B.V.¹⁶ but is in line with the decision of the AAR in the case of Morgan

¹⁵ TVM Ltd. v. CIT [1999] 237 ITR 230 (AAR)

¹⁶ ACIT v. DHL Operations B.V. [2005] 142 Taxman 1 (Mum)

Stanley & Co¹⁷. The Tribunal agreed with the CIT(A)'s view that since during the year under consideration the income of B4U India from the taxpayer constituted merely 4.69 percent of its total income, B4U India cannot be treated as dependent agent of the taxpayer. Accordingly, the Tribunal held that neither Article 5(4) nor Article 5(5) of the tax treaty was attracted in this case. Therefore, the taxpayer has no PE in India.

High Court ruling

The High Court upheld the order of the Tribunal.

The SLP has been accepted in case **Director of Income-tax (IT)-II vs. B4U International Holdings Ltd. (2016) 71 taxmann.com 182 (SC)**.

46. DIT v. Ericsson A.B., Ericsson Radio Systems A.B. and M/s Metapath Software International Ltd [2011] 343 ITR 470 (Del)

The taxpayer, a tax resident of Sweden, supplied network equipment system comprising of both hardware and software, to its customers in India. The supply of the equipment was made outside India.

The tax officer, inter alia, proceeded to hold that revenue from software supply were taxable in India as a royalty on a gross basis on the ground that the software has been licensed to the Indian customers.

The issues for consideration before the Delhi High Court, inter alia, were as follow:

- Whether the revenue from software licenses is taxable as royalty income in India?
- Whether the hardware and software components of the equipment can be segregated for the purpose of determining taxability?

Based on the facts of the case, the Delhi High Court, inter alia, observed and held as follows:

- The software supply was an integral part of the network equipment system and the software that was loaded on the hardware did not have any independent existence. There could not be any independent use of such software.

¹⁷ DIT v. Morgan Stanley & Co. [2007] 292 ITR 416 (SC)

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- In order to qualify as a royalty payment, it is necessary to establish that there is transfer of all or any rights (including the granting of any license) in respect of copyright of a literary, artistic or scientific work.
- Payment received by the taxpayer was towards the title of the equipment. Software was an inseparable part incapable of independent use and it was a contract for the supply of goods. Therefore, no part of the payment can be classified as payment towards royalty.
- Relying upon the Supreme Court ruling in *TATA Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 401 (SC), it was also held that when the taxpayer supplies the software incorporated on a CD, it has supplied tangible property.
- Therefore, the payment made by the cellular operator for acquiring such property cannot be regarded as royalty under the Act as well as under the India-Sweden tax treaty.

The issue of the taxability of supply of software was examined in light of following three facts:

- The taxpayer did not have any business connection in India.
- The supply of the equipment in question was in the nature of supply of goods, and the High Court has reached a conclusion, based on the facts of the case, that the offshore supply of the equipment was not taxable in India.
- The Indian customers did not acquire any of the copyrights.

47. eBay International AG v. ADIT [2012] 25 taxmann.com 500 (Mum)

The taxpayer Company, a tax resident of Switzerland filed income-tax return in India declaring 'Nil' income. During the year under consideration, the taxpayer operated India specific websites providing an online platform for facilitating the purchase and sale of goods and services to users based in India. The taxpayer entered into a Marketing Support Agreement with eBay India Private Limited (eBay India) and eBay Motors India Private Limited (eBay Motors) which are eBay group companies, for availing certain support services in connection with its India specific websites. The taxpayer earned revenue from the operations of its websites in India and it was claimed that such revenue was not taxable as business profits in India under Article 7 of

the tax treaty since it does not have a PE in India under Article 5 of the tax treaty. The AO held that the taxpayer had a business connection in India since eBay India and eBay Motors were group companies rendering services to the taxpayer in India. The AO held that the amount received by the taxpayer from its Indian operations is in the nature of FTS and therefore, it is taxable at 20 percent under Section 115A of the Act. The AO also held that the taxpayer had a DAPE in India in the form of eBay India and eBay Motors under the tax treaty.

The CIT(A) held that the amount cannot be considered as FTS. Further, the taxpayer had a DAPE in India under Articles 5(5) and 5(6) of the tax treaty and therefore the revenue earned by it was taxable as business profits under Article 7 of the tax treaty. Further, the CIT(A) invoked Rule 10 of Income-tax Rules, 1962 and held that 10 percent of the revenue, being income of Indian specific operations, needs to be taxed as business profits in India.

Tribunal's ruling

Fees for Technical Services

- The taxpayer's websites are analogous to a market place where the buyers and sellers assemble to transact. By providing a platform for doing business, the taxpayer cannot be considered as having rendered any managerial services either to the buyer or to the seller, for which it received fee from the seller.
- Neither the buyer nor the seller is required to avail any technical service from the taxpayer so as to enter into transaction on the website hence the taxpayer has not rendered any technical services. Also, the taxpayer does not provide technical or other personnel in the entire process.
- It is neither open nor possible for the buyers to consult the taxpayer before making any decision as regards the product to be purchased by them. There is no consultancy provided by the taxpayer at any stage, either to the buyer or the seller.
- It can be seen that apart from making its websites available in India on which various products of the sellers are displayed, the taxpayer has no role to play in effecting the sales. Hence, the fee received by the taxpayer cannot be described as FTS, but is in the nature of 'Business profits'.

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Dependent Agent Permanent Establishment

- On a perusal of the responsibilities of eBay India along with the actual expenditure incurred by it, it is clear that eBay India is involved in making awareness in India about the websites of the taxpayer and also in the collection of payments from the Indian sellers on behalf of the taxpayer and thereafter, remitting the same.
- All the expenditure incurred by eBay India and the nature of activities as provided in the agreement indicate that the website of the taxpayer, through which the actual business operations are carried on, are not directly or indirectly controlled by eBay India in any manner.
- Though, eBay India makes advertisement in India so as to create awareness amongst the sellers to get attracted towards taxpayer's websites, it has no role in directly introducing any specific customer to the taxpayer.
- The agreements between the sellers of the products and the taxpayer are entered online through the taxpayer's websites directly, without any interference or involvement of eBay India. The transactions between the buyers and sellers of the products are finalised through the taxpayer's websites operated from outside India.
- Thus, it can be seen that the agreement between the sellers and the taxpayer, and the finalisation of transactions between the vendors and the buyers, are done through the taxpayer's websites situated and controlled from abroad.
- eBay India and eBay Motors are providing their exclusive services to the taxpayer and they have no other source of income except that from the taxpayer in lieu of the provision of service. Therefore, they become the dependent agents of the taxpayer in India.
- If any of the conditions of Article 5(5) of the tax treaty is satisfied, then such dependent agents will constitute DAPes of the taxpayer in India.
- Though eBay India and eBay Motors are dependent agents as per the tax treaty, they did not perform any of the functions enumerated in clauses (i) to (iii) of Article 5(5) of the tax treaty hence they cannot be described as a DAPE of the taxpayer.
- Based on the above, the taxpayer does not have PE in India under Article 5(5) and Article 5(6) of the tax treaty.

Place of Management

- There is no definition of the term 'place of management' in the tax treaty and under the Act as well. Consequently it needs to be understood in common parlance. A 'place of management' ordinarily refers to a place where overall managerial decisions of the enterprise are taken.
- eBay India and eBay Motors are not taking any managerial decision and are simply rendering certain marketing services to the taxpayer. Further, they have no role in the operation of the websites, in the matter of entering into online business agreements between the sellers and the taxpayer or the finalisation of transactions between the buyers and sellers resulting into the accrual of the taxpayer's revenue.
- As eBay India and eBay Motors are required to perform only market support services for the taxpayer, it cannot be said that they form 'place of management' of the taxpayer's overall business.

48. P.T. McKinsey Indonesia v. DDIT [2013] 29 taxmann.com 100 (Mum)

The taxpayer is a company incorporated in and a tax resident of Indonesia. The taxpayer is a part of McKinsey group (the Group) which is engaged in providing strategic consultancy services to their clients. The Indian branches (McKinsey India) of McKinsey & Company, Inc were set up to provide similar services in India. During the year under consideration, McKinsey India has received various information from the taxpayer and was charged by the taxpayer for collating the information. These services were rendered by the taxpayer outside India. The taxpayer claimed that the amount received from McKinsey India was to be taxed as business receipt. However, the AO held that such payment was in the nature of as Fees for Included Services (FIS) as per Article 12 of the India-Indonesia tax treaty (tax treaty). The DRP held that the receipt was to be taxed as other income under Article 22(3)¹⁸ of the tax treaty.

¹⁸ Items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Agreement and arising in the other Contracting State may also be taxed in that other State

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Tribunal's ruling

- The issue of taxability of amounts pertaining to the information supplied by the taxpayer to McKinsey India has been dealt in length and decided conclusively in a series of orders of Mumbai Tribunal¹⁹. The AO has not established that the information supplied by the taxpayer was arising out of exploitation of the know-how generated by the skills or innovation of the persons who possesses such talent.
- Information received by McKinsey India was in the nature of data and the same cannot be held to be the payment received as royalty. The word 'royalty' in taxation-terminology has its distinct meaning and the amounts received by the taxpayer do not fall in that category.
- The residuary head 'Other income' under the tax treaty is analogous to Sections 56 and 57²⁰ of the Act. If certain receipt cannot be taxed under any other head, only then the Sections dealing with 'Income from Other Sources', come into play in domestic taxation matters. Similarly, under the tax treaties, if a sum can be taxed under any other Article, provisions of Article 22 of the tax treaty will not be applicable.
- Accordingly, in light of the earlier decisions of the Mumbai Tribunal, income received by the taxpayer from McKinsey India is not to be treated as Royalty and it has to be assessed as business income as per Article 7 of the tax treaty. Further, in absence of a Permanent Establishment in India, the fees received by the taxpayer are not taxable under the tax treaty.

49. **Convergys Customer Management v. ADIT [2013] 58 SOT 69 (Del)**

The taxpayer was a company incorporated in the USA. It was a tax resident of USA under the tax treaty. The taxpayer provides IT enabled customer management services by utilising its advanced information system capabilities, human resource management skills and industry experience. The taxpayer had a subsidiary in India by the name of CIS.

¹⁹ McKinsey & Company, Inc (Philippines) & Others v. ADIT [2006] 99 TTJ 857 (Mum)
DDIT (IT) v. McKinsey & Company [2011] 9 taxmann.com 298 (Mum)
Inc United States & Others v. ADIT (ITA No. 3483/M/05)
McKinsey & Company, Inc. China & Others v. DCIT (ITA No. 7239/M/02)
ADIT(IT) v. McKinsey & Company, Inc. Belgium (ITA No. 3711/M/2006)

²⁰ Section 56 and 57 of the Act deals with taxability of other income under the Act

To service its customers, the taxpayer claims to procure services from India on a principal to principal basis from CIS. The taxpayer does not carry out any business operations in India. CIS provides IT enabled call centre/back office support services to the taxpayer.

It was claimed that substantial risk of procurement of services by the taxpayer from CIS lies with the taxpayer. In its return of income, the taxpayer declared a total income of INR 40 million comprising of INR 19.22 million as interest on external commercial borrowings and an amount of INR 20.77 million as FIS. The interest and service income was earned by the taxpayer from CIS. The interest income was offered to tax at the rate of 15 percent on gross basis in accordance with Article 11 of the tax treaty and the FIS was also offered to tax at the rate of 15 percent on gross basis in terms of Article 12(4)(b) of the tax treaty.

The AO determined the taxable income at INR 2.94 billion against the declared income of INR 40 million. The AO held that the taxpayer has various forms of PE in India such as fixed place PE, Service PE and Dependent Agent PE. The AO has computed profits of INR 2.84 billion as attributable to the alleged PE in India by further estimating the revenue from Indian operations at INR 12.15 billion by allocating the global revenue in proportion of number of employees, as against the actual revenue of INR 6.19 billion. The AO also allocated expenditure (excluding direct expenditure) in proportion of number of employees. Further the AO held that the PeopleSoft license cost/maintenance charges are taxable as royalty under the provisions section 9(1)(vi) of the Act and Article 12 of the tax treaty. The AO also held that the International Private Leased Circuit (IPLC)/link charges were taxable as 'equipment royalty' in terms Explanation 2(iva) to Section 9(1)(vi) of the Act and Article 12(2) read with Article 12(3)(b) of the tax treaty.

The CIT(A) held that the taxpayer had a fixed place PE in India under article 5(1) of the tax treaty and a place of management under Article 5(2)(a) of the tax treaty. However, it did not have a Service PE in India in terms of Article 5(2)(l) of the tax treaty as the services were in the nature of included services covered under Article 12 of the tax treaty. Further, the taxpayer also did not have DAPE in India. In connection with profit attribution to the PE, the CIT(A) recomputed and reduced the amount of profits attribution from INR 2.84 billion to INR 0.43 billion.

Relying on the decision of Samsung Electronics Co. Ltd.¹, the CIT(A) held that the PeopleSoft license cost and maintenance charges received by the

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taxpayer were in the nature of royalty. IPLC/link charges do not constitute royalty in terms of provisions of Article 12 of the tax treaty as the third party service provider was using its own equipment itself while rendering the services to its customers including the taxpayer and CIS and there was no transfer of right to use, either to the taxpayer or CIS.

Tribunal's ruling

Permanent establishment

- The employees of the taxpayer frequently visited the premises of CIS to provide supervision, direction and control over the operations of CIS and such employees had a fixed place of business at their disposal. CIS was practically the projection of taxpayer's business in India and carried out its business under the control and guidance of the taxpayer and without assuming any significant risk in relation to such functions.
- Besides taxpayer has also provided certain hardware and software assets on free of cost basis to CIS. Thus, the findings of the CIT(A) that taxpayer has a fixed place PE in India under Article 5(1) of the tax treaty was upheld. The Tribunal held that CIS did not constitute a DAPE of the taxpayer in India as the conditions provided in Article 5(4) of the tax treaty were not satisfied.

Attribution of profit

- It is not disputed that the details of aggregate customer revenue from the work subcontracted to CIS and estimated operating income of the taxpayer with respect to such revenue were submitted before the AO.
- The operating income was computed considering the global operating income percentage of the customer care business i.e. 10.55 percent. This percentage has been derived from the filings made by the taxpayer with the Securities and Exchange Commission of USA.
- Relying on the CBDT Circular No. 5 of 2004, various decisions²¹ and OECD Guideline, the Tribunal held that overall attribution of profits to the PE was a TP issue and no further profits can be attributed to a PE once an arm's length price has been determined for the Indian associated enterprise, which subsumes the FAR of the alleged PE.

²¹ DIT v. Morgan Stanley [2007] 292 ITR 416 (SC), Set Satellite (Singapore) Pte Ltd. v. DDIT [2008] 307 ITR 205 (Bom), Rolls Royce Singapore Pvt. Ltd. v. ADIT [2011] 202 Taxman 45 (Del), DIT v. BBC Worldwide Ltd. [2011] 203 Taxman 554 (Del)

- The risk was outside India with the taxpayer as the CIS was remunerated at Cost+14 percent irrespective of failure of service delivery. Even otherwise, no attributions can be made on account of risks in terms of Article 7(5) of the tax treaty.
- The employees/representatives of the taxpayer visited India for short duration and for providing training under the Technical Services Agreement. Further, the seconded personnel were employees of CIS working under its control and supervision and not the employees of the taxpayer. It cannot be said that they were performing any entrepreneurial services to manage risk in India.
- While computing the profit of the taxpayer as a multi-national enterprise, there was no question of applying the provisions of the Act. The expenditure incurred outside India have been incurred by the taxpayer for its business outside India and not by the alleged PE. Hence, the AO/CIT(A) was not correct in invoking the provisions of Section 44C of the Act in attributing the income of the taxpayer without allowing the cost incurred to earn the revenue outside India thereby attributing the entire receipts.
- For the purpose of computing the taxable profits attributable to the alleged PE, even the executive and general expenditure are allowable. The action of the lower tax authorities in invoking Section 40(a)(i) in respect of all expenditure incurred by the taxpayer as a multi-national enterprise was not in accordance with Article 7(3) of the tax treaty.
- The Tribunals held that the correct approach to arrive at the profits attributable to the PE should be as under:
 - Compute global operating income percentage of the customer care business as per annual report.
 - This percentage should be applied to the end-customer revenue with regard to contracts/projects where services were procured from CIS. The amount arrived at is the operating income from Indian operations.
 - The operating income from India operations is to be reduced by the profit before tax of CIS. This residual is now attributable between USA and India.
 - The profit attributable to the PE should be estimated on aforesaid residual.

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- The Tribunal relied on various decisions²² and held that the adoption of higher figure of 15 percent as held by the Supreme Court in the Hukum Chand Mills Ltd. for attribution of taxpayer's Indian PE operations will meet the ends of justice. Thus, the attribution of Indian PE income should be made at 15 percent of profit retained by taxpayer in the USA.

Royalty – license charges

- The Tribunal relying on the decisions in the case of B4U International Holding²³ and Nokia Networks OY²⁴ held that even though the Finance Act, 2012 has made an amendment in section 9(1)(vi) of the Act and widened its scope, however, the same does not impact the provisions of tax treaty in any manner.
- The purchase of software would fall within the category of copyrighted article and not towards acquisition of any copyright in the software and hence the consideration should not qualify as royalty. Even otherwise, the payment is in the nature of reimbursement of expenditure and accordingly not taxable in the hands of the taxpayer.

Equipment royalty

- The taxpayer/CIS did not have any control or possession over the equipment i.e. the network facilities are under the control of and maintained and operated by the service providers. The taxpayer/CIS merely avail a service. Accordingly, the Tribunal relied on various decisions²⁵ and held that that the link charges do not qualify as 'equipment royalty' in terms of Article 12 of the tax treaty and hence are not taxable in India.

²² Anglo French Textile Company Ltd. v. CIT [1953] 23 ITR 101 (SC), Hukum Chand Mills Ltd. Vs. CIT [1976] 103 ITR 548 (SC)

²³ B4U International Holding v. DCIT [ITA No 3326/Mum/2006]

²⁴ DIT v. Nokia Networks OY (ITA No 512 of 2007)

²⁵ Bharat Sanchar Nigam Ltd. v. Union of India [2006] 282 ITR 273 (SC), Dell International Services India Pvt. Ltd. [2008] 172 Taxman 418 (AAR), Cable & Wireless Networks India Private Limited [2009] 182 Taxman 76 (Del), Asia Satellite Telecommunications Co. Ltd. v. DIT [2011] 332 ITR 340 (Del), Yahoo India Pvt Ltd. v. DCIT [ITA No. 506/Mum/2008], Standard Chartered Bank v. DDIT [ITA No. 3824/MUM/2006]

- Though Asia Satellite case is a decision on the domestic law but also makes an observation regarding tax treaty that 'Even when we look into the matter from the standpoint of tax treaty, the case of the taxpayer gets a boost'. This observation supports the taxpayer's contentions in this case.
- The Tribunal held that there is no transfer of the right to use, either to the taxpayer or to CIS. The taxpayer has merely procured a service and provided the same to CIS, no part of equipment was leased out to CIS. Accordingly, the Tribunal held that the said payments do not constitute royalty under the provisions of Article 12 of the tax treaty.

50. Varian India Pvt Ltd v. ADIT [2013] 33 taxmann.com 249 (Mum)

The taxpayer is a branch of VIPL, USA, which in turn is a 100 percent subsidiary of Varian Inc, USA. Varian Inc was engaged in designing, manufacturing and marketing of its technological products such as scientific instruments, vacuum technologies, contract electronics manufacturing and analytical lab instruments. The taxpayer was engaged in the distribution of products manufactured by Varian Group of companies (VGCs) all over the world. The VGCs are the entities in USA, Australia, Italy, Switzerland and Netherlands. VIPL has entered into Distribution and Representation Agreement (DR Agreement) with VGCs for supply and sale of analytical lab instruments to the Indian customers directly.

The taxpayer carries out two types of sale of Varian products in India i.e. (i) direct sale and (ii) indent sale. In the case of direct sale, the taxpayer directly imports spare parts from VGCs and sells them to Indian customers directly on its own account on principal-to-principal basis. These spare parts are made available at discounted price by various Associates Enterprises (AEs). In the case of indent sale, VGCs sells analytical lab instruments to the Indian customers directly and the taxpayer carries out pre-sale activities like liaisoning and other incidental post-sale support activities for which it was entitled to commission.

In pursuance of the DR Agreement with VGCs in relation to the indent sale, the taxpayer has earned commission income. The commission income in respect of indent sale and income from direct sales has been fully offered for taxation in India by the taxpayer.

The AO held that the taxpayer is a dependent agent PE of three companies i.e. Varian USA, Australia and Italy under Article 7(1) of the relevant tax

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treaty. Accordingly, as per Article 7 of the respective tax treaty, dealing with “Force of Attraction Rule”, profits of these foreign companies attributable to their business in India are also taxable in the hands of the taxpayer being PE of three group of companies. Further, in the absence of actual profit attributable to the PE of these three VGCs, the AO applied the provisions of Rule 10 of the Rules and estimated profit attributable to the PE at 10 percent of the operating profit from the business of these three companies. The CIT(A) upheld the order of the AO.

Tribunal’s ruling

Agency PE – Dependent Agent

- On perusal of the DR Agreement, it indicates that the taxpayer has no authority and also cannot negotiate or conclude contracts on behalf of VGCs. It only provides marketing support liaisons activity for pre-sale and incidental and ancillary post-sale activities. The title of the goods supplied by VGCs is directly passed on to the customers and the taxpayer neither undertakes any risk or title of the product at any point of time.
- The order relating to indent sale are only introduced and liaised by the taxpayer and not secured by it and the sale orders are not binding on the VGCs until accepted by them. The taxpayer has no authority to accept orders on behalf of any of the VGCs. The taxpayer is providing services to various VGCs and it has not devoted only for one foreign enterprise. Accordingly, the taxpayer does not fulfill any of the condition enumerated in Article 5(4) of the tax treaty.
- The language of India-Australia and India-Italy tax treaty is similarly worded. However, there is an additional clause under these tax treaties relating to the activity of manufacturing or processing goods belonging to the foreign enterprise. Since the taxpayer does not manufacture or process any other products developed or manufactured by VGCs, the conditions of Article 5(4) of India-Australia and India-Italy tax treaty also not been fulfilled.
- As per the OECD Commentary the agent can be said to be dependent, if his commercial activities for the enterprise are subject to detailed instructions or to comprehensive control; and the entrepreneur risks are borne by the enterprise it represents. In the present case, the taxpayer does not have authority to conclude contracts as none of the

orders booked through the taxpayer is binding on the foreign enterprise.

- Further, on reference to DR Agreements, it indicates that none of the risks like market risk, product liability risk, R&D risk, credit risk, price risk, inventory risk or foreign currency risk is undertaken by the taxpayer. All these risk factors are borne by VGCs.
- On a perusal of statement of sales it is evident that the percentage of commission income and sales from three VGCs are normal and with regard to Varian Inc USA., the activities of the taxpayer are between 5 to 7 percent. Hence, it cannot be said that the taxpayer is devoted wholly or almost wholly on behalf of any one VGC as per Article 5(5) of the tax treaty.
- Further, the TPO held that the transactions were at arm's length. Even the AO has also not adversely held that compensation in the form of commission is not at arm's length, thus the second condition is also not satisfied. Thus, as per Article 5(5) of the tax treaty also, the taxpayer cannot be held to be agent for constituting a PE in India for the various VGCs.

Subsidiary PE

- Merely because the taxpayer is a subsidiary of Varian Inc USA, VIPL or its branch would not constitute PE of Varian Inc USA under Article 5(6) of the tax treaty. Thus, as per Article 5(6) of the tax treaty it cannot be treated as PE for Varian Inc USA or any other VGCs.

On profit attribution

- In order to tax business profits of the enterprise under Article 7 of the tax treaty two basic conditions needs to be fulfilled i.e. the foreign enterprise should have PE in India for the purpose of selling goods and direct sale by the foreign enterprise is the same or similar kind of goods or merchandise as sold by the PE in India. However, in the present case since the taxpayer does not fulfill such conditions; the profits of VGCs cannot be taxed.
- The taxpayer is showing the entire income as is reasonably attributable to the operations carried out in India as per Section 9(1)(i) of the Act in view of the decision of the Supreme Court in the case of

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Hyundai Heavy Industries Co. Ltd²⁶ and therefore, no further profits could be attributed.

- Since the taxpayer does not have PE in India, the attribution of 10 percent profit margin on the basis of global accounts of VGCs, as applied by the AO cannot be made.
- The Delhi High Court in the case of Rolls Royce Plc²⁷ has held that the Indian company was 100 percent subsidiary of Rolls Royce Plc which was held to be PE looking to the functions performed. However, in the present case, the issue is not whether the Indian branch of VIPL is a PE of VIPL or not but whether the VIPL through its Indian branch is a PE of other VGCs. Therefore, the said decision was not applicable on the facts of the present case.

51. ITO v. Pubmatic India Pvt. Ltd. [2013] 36 taxmann.com 100 (Mum)

The taxpayer, an Indian company, and its holding company in US, engaged in the business of providing services of internet advertising and marketing services including e-commerce transactions and provision of related technologies, systems, consultancy, devices, etc. When the taxpayer place order to its parent company, the parent company books space on relevant foreign website and then sales space to the taxpayer at cost plus mark-up. The taxpayer in turn sells the said space to its Indian client at cost plus profit.

During the year under consideration the taxpayer made payment to US Company for purchases of online advertisement space. The taxpayer claimed that the business income of US Company was not taxable in the absence of PE and therefore, withholding of tax was not required on such payment. The AO disallowed the expenditure while computing taxable income of the taxpayer and held that the taxpayer was required to withhold the tax. The CIT(A) deleted the addition by the AO.

Tribunal's ruling

On perusal of the arrangement made between the taxpayer and US Company it indicates that neither of the party is doing the business activity on behalf of other. Further, the transactions are independent business transaction wherein the respective margins are recovered from each other.

²⁶ Hyundai Heavy Industries Co. Ltd [2007] 291 ITR 482 (SC)

²⁷ Rolls Royce Plc v. DIT [2011] 339 ITR 147 (Del)

The transaction of payment towards the purchase of space on foreign website by the taxpayer for its client in any case does not constitute a transaction carried out by the taxpayer on behalf of its US Company.

The taxpayer was doing the business on behalf of its client and offering the income earned from the said business transaction for taxation in India. Therefore, the transaction of purchase of space on foreign website by the taxpayer from US Company cannot be treated as PE.

Merely because one of the director is common in both the companies does not constitute the taxpayer as PE. Even otherwise the common director and holding of the company by itself does not constitute either company as a PE of the other as per Article 5(6) of the tax treaty. The similarity of business activity does not, by itself, indicate that the taxpayer is acting or doing business on behalf of its parent company so that it constitute a Agency PE of US Company.

The record does not indicate that either the taxpayer or US Company is providing the service/goods to the clients of the other party. Therefore, when none of the party is dealing with the clients of the other party then the activity between the taxpayer and US Company are independent business activities. There is no written agreement between the taxpayer and US Company. Though the Transfer Pricing Study specifies an arrangement between the taxpayer and AE, however, that does not mean that the taxpayer having a written agreement.

When the transactions are claimed to have taken place at ALP, then there is no question of the taxpayer doing the business activity on behalf of US Company. The transaction between the taxpayer and the US Company are independent business between two parties.

The risk and reward of the business carried out by the taxpayer is born by the taxpayer which indicate that it is the taxpayer who is answerable to the customers and therefore, the activity of purchase of space on website from the parent company is on principle to principle basis. Thus, purchase of advertisement space on foreign website falls under business income of US Company under the tax treaty. However, in the absence of PE of US Company, the said business profits were not taxable in India. Accordingly, the taxpayer was not required to deduct tax in respect of said amount which is trading receipt in view of the decision of the Supreme Court in case of GE India Technology Centre Pvt. Ltd.

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52. **Samsung Heavy Industries Co. Ltd. v. DIT [2014] 221 Taxman 315 (Utt)**

The taxpayer, a foreign company, entered into a contract with ONGC and Larsen & Toubro as consortium partners. The taxpayer was having Project Office in India. Under the contract, the taxpayer received revenue in respect of inside India activities as well as outside India activities. In respect of inside India activities, it has incurred certain expenses and after deducting such expenses, it has earned a loss and therefore, filed loss return of income. The AO refused to accept the deduction claimed by the taxpayer. The AO also held that 25 percent of the revenues claimed by the taxpayer have been earned from outside India activities should be brought to tax in India. The Tribunal confirmed the order of the AO.

High Court's ruling

- There was no finding recorded by the tax authority that the revenue earned by the taxpayer were said to have been received on account of within India activity. As per the tax treaty, if an enterprise does not have PE in India, it has no obligation to either submit any tax return with, or pay any tax to India.
- Neither the AO, nor the Tribunal has recorded any evidence to justify that the PO of the taxpayer is a PE in India through which it carried on business and 25 per cent of the gross receipt is attributable to the said business.
- The High Court set aside the judgment and order under appeal as well as the assessment order, in so far as the same relates to imposition of tax liability on the 25 percent of the gross receipt upon the taxpayer.
- Accordingly, the High Court held that tax liability could not be fastened without establishing that the same is attributable to the tax identity or PE of the enterprise situate in India.
- The SLP has been granted in **DIT vs. Samsung Heavy Industries Co. Ltd (2017) 245 Taxman 47 (SC)**.

53. **DIT v. E Funds Corporation [2014] 226 Taxman 44 (Del)**

The taxpayers were residents of USA, e-Fund Corp. was the ultimate holding company of e-Fund India, a company incorporated and resident of India, and also of e-Fund Inc. The taxpayers had four main business lines, namely

electronic payments, ATM management service, decision support and risk management and professional services. e-Fund India had performed back office operations in respect of the first three. This included data entry operations etc. in respect of decision support and risk management.

The Tribunal in the taxpayers own case²⁸ held that the taxpayers have entered into contracts with their clients for providing certain IT enabled services which were either assigned or sub-contracted to e-Funds India for execution. Therefore, both, eFunds Corporation and e-Funds India came under legal obligation to provide services to clients of eFunds Corporation. Further, based on the FAR analysis by taxpayers and e-Funds India, it was clear that e-Funds India was not having requisite software and database needed for providing IT enabled services independently; therefore, to that extent they were made available by taxpayers to e-Funds India free of any charges. Also, e-Funds India did not bear any significant risk as ultimate responsibility lay with taxpayers.

In view of above and further having regard to fact that entire activities of taxpayer in India were carried out by e-Funds India Ltd. (an agent) and said agent had not been remunerated on arm's length price basis, it was held that taxpayer had PE in India in respect of back office operation and software development services being carried out by its subsidiary. Accordingly, taxpayer's income was liable to taxed in India in respect of operations performed by subsidiary company on its behalf.

High Court's Ruling

A subsidiary per se does not form a PE

Subsidiary constitutes an independent legal entity for the purpose of taxation. Holding or a subsidiary company by themselves would not become PE of each other.

As per the Article 5(6) of the tax treaty, the company, which controls or is controlled and carries on business in the other State by itself, would not constitute PE of the other company. A subsidiary can become a PE of the holding/controlling company or the related company, if it satisfies the requirements of other paragraphs of Article 5, notwithstanding and negating the protection provided under Article 5(6), which recognises legal independence of the two entities for tax purposes.

²⁸ E Funds Corporation v. ADIT [2010] 42 SOT 165 (Del)

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Fixed place PE

There was no material to hold that the taxpayers (i) had a fixed place of business in India through which business of enterprise was wholly or partly carried on and (ii) had right to use any of the premises belonging to e-Fund India. Accordingly, Article 5(1) of the tax treaty cannot be invoked to constitute a PE in India.

Following factors are not the relevant to determine and decide location PE:

- e-Fund India provides various services to the taxpayers and was dependent on them for its' earning
- e-Fund India did not bear sufficient risk
- e-Fund India was reimbursed the cost of the call centre operations plus 16 percent basis or that the basis of margin fixation was not known
- direct or indirect costs, and corporate allocations in software development centre or BPO
- assignment or sub-contract to e-Fund India
- whether or not any provisions for intangible software was made or had been supplied free of cost

Even if the foreign entities have saved and reduced their expenditure by transferring business or back office operations to the Indian subsidiary, it would not by itself create a fixed place or location PE.

The fact that the subsidiary company was carrying on core activities as performed by the foreign taxpayer does not create a fixed place PE. If an enterprise enters into contracts, assign or sub-contract works or render services to a third party on behalf of the principal, by itself would not lead to a subsidiary becoming a PE unless the relevant requirements of Article 5 are satisfied.

Further, as the taxpayers did not have any branch office or factory or workshop in India, and merely because they had a subsidiary in India, that by itself did not create a fixed place of business/location PE within the meaning of Article 5(2)(b) to (k) of the tax treaty.

PE due to 'Place of Management'

President of e-Fund India had provided management support services in U.K.

and Australia, while certain personnel of South-east Asia region had provided marketing support services to e-Fund India as well as e-Fund group entities overseas. Accordingly employees of said entities reported to the President who in turn was reporting to e-Fund Corp.

Aforesaid factual position prima facie indicates that the said activities may have resulted in a PE under Article 5(2)(a) under the heading 'Place of Management' but the said provision has not been invoked. The High Court held that extent and timing of applicability of the 'Place of Management' principle in such cases, require findings of facts at the first instance and cannot be made matters to be decided for the first time in an appeal before the High Court under section 260A of the Act.

Article 5(3) and its over-riding effect and consequences

Article 5(3) is a non-obstante provision which overrides Article 5(1) and 5(2) of the tax treaty. While analysing whether taxpayer has PE, first and foremost, Article 5(1)/(2) should be applicable but then if the activities fall under the Article 5(3), PE cannot be created for imposing tax in the second state.

Service PE

Employees of E-Fund India were their employees, i.e. employees of an Indian entity and not employees of the taxpayers. The employees of e-fund India did not become other personnel of the taxpayers, once and if the said persons were defacto and de jure employed by the Indian entity/enterprise.

The words 'employees and other personnel' under the Article 5 of the tax treaty have to be read along with the words 'through' and 'furnishing of services' by the foreign enterprise within India. Thus, the employees and other personnel must be of non-resident to create a Service PE.

Agency PE

Subsidiary by itself cannot be considered to be a dependent agent PE of the Principal. However, a subsidiary may become dependent or an independent PE agent provided the tests as specified Article 5(4) and (5) are satisfied.

It was not the case of tax department that e-Fund India was authorised and habitually exercised authority to conclude contract or was maintaining stock or merchandise from which it delivered goods or merchandise on behalf of the taxpayer or secured orders on behalf of the taxpayer. Therefore, the conditions and requirements of Article 5(4)(a) to (c) are not satisfied.

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The fact that e-Fund India had provided necessary inputs to e-Fund Corp or e-Fund Inc. to enable them to enter into contracts which were assigned to e-Fund India will not make e-Fund India a PE of the taxpayer.

As per Article 5(5), an agent is not considered to be an independent agent if his activities are wholly or mostly wholly on behalf of foreign enterprise and the transactions between the two are not made under arm's length conditions. The twin conditions have to be satisfied to deny an agent, the character of an independent agent. The transactions between the taxpayers and e-Fund India were at arm's length and were taxed on arm's length principle and therefore, requirements of Article 5(5) are not satisfied. Consequently, there was no Agency PE of the taxpayer in India.

Attribution of profits

The activities, which were not undertaken by e-Fund India and the assets of the taxpayers outside India, cannot be taken into account or attributed for earning/income of the taxpayers.

The taxpayers activities though broadly divided into four heads were interconnected and not independent. Method of apportionment has to be fair, rational and logical. Assets and net income criteria applied must collate and refer to the assets which have contributed to the earning of the net income. In the MAP proceedings a formula was adopted and it should be consistently followed but if the said formula was irrational and inappropriate, it could be corrected in subsequent years.

The anomaly while computing the proportion of net income attributable to Indian PE was that the net income of the group less income of e-Fund India was attributed to the group assets including assets of e-fund India. The Tribunal was correct in rectifying this anomaly. In view of the income declared and taxed in the hands of e-Fund India, nothing remains to be attributed or taxed in the hands of the taxpayers.

This case has been affirmed by the Supreme Court in the case of **ADIT vs. E-funds IT Solution Inc. (2017) 251 Taxman 280 (SC)**.

54. Renoir Consulting Ltd. v. DDIT [2014] 64 SOT 28 (Mum)

The taxpayer, a company being a tax resident in Mauritius had business in India, of applying the Renoir Performance Improvement Programme (RPIP), designed by it, for improving the management performance quotient of an enterprise by enhancing the operating parameters, as reducing costs,

improving the work methods/services, providing efficient management control, etc.

The projects undertaken by the taxpayer for its clients in India were aimed at improving the market share and also the improved financial results. Accordingly, the total consideration receivable by the taxpayer would be for (i) Development and improvement programme and (ii) Providing information and scientific knowledge.

During the year under consideration, the taxpayer received an amount from Godfrey Philips India Ltd. (GPI), an Indian company, on contract/s executed in India. The taxpayer claimed that there was no PE in India under the India-Mauritius tax treaty (the tax treaty), and therefore, the business income earned from GPI could not be brought to tax in India. However, this amount was assessed as business income by the AO on the grounds that the taxpayer has a PE in India.

Tribunal's ruling

The word 'permanent' in the term 'permanent establishment' does not signify a permanent character, or that the right to use the place should be perpetual, but that there must be a certain degree of permanence. A fixed place would include a movable place of business, viz. a petroleum drilling rig may constitute a PE if it is moved frequently from one location to another. How the fixed place or the right to use the same is secured is of little significance and the same may be owned, rented or otherwise acquired in any other manner. The establishment must have a commercial coherence or purpose, without the same, the enduring quality would be immaterial.

The initial understanding of the project had crystallised into a definite program of implementation on the basis of regular interactions between the parties, which requires the taxpayer's presence in India. The top management's role was to provide strategic guidance and policy framework to the extent required for the project at hand. Further, the taxpayer continues its same personnel for the sake of better and smooth implementation of the project. The continued presence of the taxpayer, and not of its particular person is relevant.

A fixed place of business, as contemplated in the definition of PE under Article 5 of the tax treaty, does not imply or is confined to a place where the top management of the company is located. A branch of an enterprises may be its PE. It is for the taxpayer to specify as to how and from where it has

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performed its work during its continued stay of 874 man-days for the consultants and 81 days for the principal consultants, since it was in the intimate knowledge of its affairs.

The communications between taxpayer's personnel in India and the head office has been carried out in India from a place in the vicinity of the place of the stay. Further, whether the communication has taken place from the hotel room through the medium of internet using laptops – a tangible asset/s, by the personnel, or similar facilities provided by the hotel or by a retail outlet providing such services is immaterial.

Based on the *modus operandi* to be adopted, the regular interviews, interactions, meetings, training sessions and seminars, etc., both by the consultants and the principal consultants at the GPI's premises, is as much a part of the work undertaken by the taxpayer, as is the independent collection, collation, analysis and review, etc. of the data/information being sought from the organisation during any phase of the project management.

The stated deliverables for the projects are in complete harmony and sync with the stated objectives of the RPIP. Accordingly, the services rendered by the taxpayer were not merely preparatory and auxiliary services though contended by the taxpayer.

Based on the work nature/profile and the *modus operandi* followed, it is concluded that some place is at the disposal of the taxpayer or its employees during the entire period of the stay in India. Accordingly, there is a fixed place PE of the taxpayer in India.

55. DIT v. R & B Falcon Offshore Ltd. [2014] 44 taxmann.com 400 (Utt)

The taxpayer brought in a rig and operated the said rig for and on account of its clients in India. Those rigs were deployed for such purpose on dates, as were furnished by the taxpayer and the same remained unused during the dates as furnished by the taxpayer on account of maintenance and repair. The AO held that the Article 5(2)(j) of the tax treaty used the word 'used' without furnishing meaning to the said word. Accordingly, meaning of the said word should be culled out from the Act which includes 'ready for use' and therefore, even during the time of repair and maintenance, the rig was lying ready for use. Thus, the rig having been used for more than 120 days during the relevant years, the taxpayer had a PE in India, in the form of the said rig. The CIT(A) upheld the AO's order.

High Court's ruling

The High Court referred to the decision of the Delhi Income-tax Appellate Tribunal in the taxpayer's case wherein it was held that the word 'used' has sufficiently been explained in the tax treaty, requiring no further explanation and hence there is no scope of entering into the Act. The word 'used' has been used in the tax treaty in conjunction of 'an installation or structure for exploration or exploitation of natural resources and only if so used for a period of more than 120 days in 12 month period' thereby, made it clear that the tax treaty meant user of installation and structure for exploration or exploitation of natural resources and not merely being 'ready for use'.

Based on the above, the High Court held that the period during which a rig in India is merely 'ready for use' but not actually used, shall not be considered to determine the existence of a PE.

The SLP of the Revenue has been dismissed in case [2014] 51 taxmann.com 384 (SC).

56. DIT v. Set Satellite (Singapore) Pte Ltd [2014] 225 Taxman 1 (Bom)

The taxpayer, a Singapore based company, engaged in the business of acquiring rights in television programmes, motion pictures and sports events and exhibiting the same on its television channels from Singapore. During the year under consideration, the taxpayer entered into an agreement with Global Cricket Corporation Private Limited (GCC), a Singapore based company. As per the terms of the agreement, the GCC granted rights to the taxpayer throughout the licence territory. The licence territory as defined in the agreement, *inter alia*, included Indian territory also. In terms of the said agreement, the taxpayer made payment to GCC for acquisition of telecast rights without deduction of tax.

High Court's ruling

- The liability for the payment was incurred by the taxpayer in connection with its broadcasting operations in Singapore and it has no connection with the marketing activities carried out through its PE in India.
- There was no economic link between the payments made by the taxpayer. Even with regard to the PE of the taxpayer in India, the Tribunal's finding of fact is that the economic link is entirely with the taxpayer's head office in Singapore. Therefore, the payment to GCC

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cannot be said to have been incurred in connection with the taxpayer's PE in India.

- The economic link has been traced from the nature of the agreement between the payer and the Singapore party. The liability to pay royalty has not been borne by the PE of the taxpayer in India.
- The High Court affirmed the findings of the Tribunal and held that such issue cannot raise any substantial question of law. Once it does not raise any substantial question of law, then, the appeal was liable to be dismissed. It was also dismissed because the view taken by the Tribunal in the given facts and circumstances cannot be said to be perverse or based on no material.

57. **Oxford University Press., In re [2014] 45 taxmann.com 282 (AAR)**

The applicant is an Indian branch of Oxford University Press, U.K., and is engaged in publishing, printing and reprinting of educational books for schools, Universities, etc. The applicant has appointed Ms Geetha as 'Resident Executive', a resident of Colombo, Sri Lanka and she is carrying on duties and responsibilities exclusively for the applicant. She is being paid remuneration and reimbursement of expenses as per her letter of appointment, which is remitted to her Bank account in Colombo from the applicant's bank account in India.

AAR ruling

- The purpose of Ms Geetha's job is to be responsible for achieving the sales and collection budgets in the territory assigned through planning and aggressive promotion of the relevant titles covering Indian school books, etc. Principal accountabilities of her job were to achieve the given sales and collection targets on time, to grow existing market share by maximizing adoptions and developing new markets, to enhance Oxford University Press (OUP) Brand image, etc.
- Main duties and responsibilities of her job included, providing value added services in terms of workshops and other educational activities, to get more business and collection within the credit limit, to be aware of competitor's product, etc.
- Based on the above, the services rendered are basically for promotion of sales and brand name of the applicant in Sri Lanka. The job description fits in more with a marketing executive.

- There is no definition of technical services in the tax treaty and therefore, in order to examine whether the payment is FTS, the AAR had to resort to provisions of the Act.
- The services rendered by Ms Geetha, do not fall under Explanation 2 to section 9(1)(vii) of the Act, namely, managerial, technical or consultancy services and therefore, are not technical services as defined in the Act.
- Ms Geetha is a non-resident in India and the services are rendered outside India. Accordingly, the payment made to Ms Geetha is not taxable either under the Act or under the tax treaty.
- Though the payments falls under Article 14 (Independent personal services) of the tax treaty, the same is not taxable in India.
- The reimbursement of expenses are directly linked with her services in Sri Lanka for the applicant. Based on the same reason as discussed above, the reimbursement of those expenses will also not be taxable in India under the provision of the Act or under the tax treaty.

58. Nortel Networks India International Inc. v. DDIT [2014] 65 SOT 158 (Del)

The taxpayer was a company incorporated in USA. It is a group concern of Nortel group, which was a leading supplier of hardware and software products for GSM cellular radio telephones system. The Indian subsidiary of the Nortel group, Nortel Networks India Pvt. Ltd., entered into a contract with Reliance Infocom for supply of hardware equipment. Immediately after the signing this contract, it was assigned by the Indian subsidiary to the taxpayer without any consideration.

In terms of the said contract, the taxpayer has supplied telecommunication hardware to Reliance Infocom. The equipments supplied by the taxpayer was purchased from a group company i.e. Nortel Canada. Nortel Canada was not engaged in providing any services and undertook only liaison activities in India.

The AO held that the taxpayer does not have any manufacturing or trading infrastructure. It does not have any financial or technological capability of its own. The taxpayer was only a paper company incorporated for the sole purpose of evading taxes in India. Nortel India was a fixed place of business and dependent agent PE of the taxpayer as well as it was business

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connection of the taxpayer in India. The AO observed that the taxpayer and Nortel Canada cannot be held as two separate entities. The CIT(A) upheld the order of the AO.

Tribunal's ruling

Permanent Establishment

- The contract entered between the Nortel group and the Reliance Infocom was a turnkey contract, indivisible contract for supply, installation, testing, commissioning etc. Nortel India had undertaken the responsibility for negotiating and securing the contracts. The contract for installation and commissioning was also undertaken by Nortel India.
- The above arrangements indicate that the taxpayer was getting its work executed through Nortel India. The taxpayer was merely a shadow company of Nortel group and for all practical purposes, all the facilities and services available to the Nortel group of companies are equally available to the taxpayer.
- Since the hardware supplied by the taxpayer was installed by Nortel India and the contracts were pre-negotiated by the same, it was constituted a fixed place of the business and dependent agent PE of the taxpayer in India.
- The LO of Nortel Canada was rendering all kinds of services to all the group companies including the taxpayer. The LO pertaining to Canadian company constituted fixed place PE of the taxpayer in India.
- The taxpayer through Nortel India and LO approached the customer, negotiated the contract, bagged the contract, supplied equipment, installed the same, undertook acceptance test after which the system was accepted. The equipment remains in the virtual possession of Nortel group till the equipment is set up and acceptance test is done.
- Employees of group companies did visit in India in connection with project in India. Thus, this indicates the employees of the group companies did carry out business of the taxpayer through the premises of LO or the premises of the subsidiary. Thus, the entire business enterprise activities of the taxpayer were managed by the subsidiary in India and the requisite supply is made from abroad.

- The contract does not only need loading of the equipments in the ship, but includes number of activities which are carried out in the Indian territory and the compensation/remuneration for that was also included in the consideration. The compensation which has been represented to a sale consideration for the equipment represents the payment for works contract where entire installation and customisation has been carried out in India.
- The subsidiary has not only acted as a service provider for the taxpayer, but at the same time acted as a sale outlet co-operating with after sale service and also providing any assistance or service requested by the taxpayer.
- The assignment agreement between Indian subsidiary, the taxpayer, the parent company i.e. Nortel Network Canada, and Reliance Infocom, indicates that the contract initially signed by the Indian company which in turn assigned to the taxpayer and all the risk and responsibility in this regard are assumed by the parent company.
- Accordingly, the activities of the taxpayer in India constitute PE under Article 5 of the India-USA tax treaty (tax treaty). The activities carried out by the PE are the core activities of the taxpayer resulting in generation of income to the taxpayer and they cannot be considered to be preparatory and auxiliary and therefore, the contention of the taxpayer that it do not have PE in India was rejected.

Profit attribution

- The accounts of the taxpayer furnished in the assessment proceedings have no sanctity and the same were not audited. The gross trading loss incurred from transaction within the group cannot be explained except for the reasons, that it has been designed as such to avoid taxation in India.
- The Tribunal observed that for all purposes, the accounts of the Nortel Group, would give a true and correct picture of the profit of the taxpayer. Hence, AO's reference to the global accounts of the Nortel and gross profit margin percentage as 42.6 per cent was accepted. Further, the AO has only allowed 5 per cent of the turnover as deduction pertaining to other selling general and marketing expenses.
- The lower authorities were justified in resorting to Rule 10 of the

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Rules. However, when profits are computed under Rule 10 of the Rules after applying the profit rate, the expenses pertaining to the PE have to be allowed as deduction.

- Income of the PE has to be computed based on the facts of each case. In the present case, an attribution of 50 per cent of the profits to the activities of PE in India would be a reasonable attribution in the taxpayer's case.
- The Tribunal observed that the CIT(A) has directed the AO to allow expenses relatable to PE. Further, it was directed to allow selling general and marketing expenses and R&D expenses. Thereafter, 50 per cent of the resultant figure has been attributed to PE. The Tribunal uphold the CIT(A)'s order.

The case has been set aside by Delhi HC in **[2016] 69 taxmann.com 47 (Delhi)**. However, the SC has granted SLP **[2017] 81 taxmann.com 417 (SC)** in favour of the revenue.

59. GFA Anlagenbau GmbH v. ACIT [2014] 34 ITR(T) 73 (Hyd)

The taxpayer is a German company engaged in the activity of supervision, erection, commissioning of plant and machinery for steel and allied plants in India. It entered into an agreement with four Indian purchasers¹ for the supervision, erection, ramp up, commissioning, demonstration of performance, performance guarantee test, etc., of various 'plant and machinery' for their steel and allied plants.

During the years²⁹ under consideration, the taxpayer had received receipts from Indian purchasers for rendering technical and supervision services. The taxpayer had rendered services to the Indian purchasers by engaging foreign technicians at the work-sites in India, and the total stay of these technicians on one project (out of four projects) had exceeded 183 days. The AO held that since the activities carried on by the taxpayer through its employees exceeded six months, it was liable to be assessed under Section 44D³⁰ or Section 44DA³¹ of the Act. The AO also held that since the taxpayer was

²⁹ Assessment Years 2005-06, 2006-07, 2007-08, 2008-09, 2009-10

³⁰ Special provisions for computing income by way of royalties, etc., in the case of foreign companies

³¹ Special provision for computing income by way of royalties, etc., in case of non-residents

having PE in India under Article 5 of the tax treaty, its income was liable to be taxed under the head 'business profits' under Article 7 of the tax treaty. The DRP directed the AO to impose tax, applying a rate of 40 per cent in addition to surcharge and education cess, as per Section 44DA of the Act.

Tribunal's ruling

- As per the definition of a PE under Section 92F(iii) of the Act, the supervisory activities do not constitute a fixed place of business, in as much as the taxpayer renders its services at the project sites of its clients. Further, the taxpayer does not own or operate such sites independently but rather such sites were provided by its clients under the contractual obligation.
- In the present case, the taxpayer was supervising the project of an Indian company and had no fixed place of business. Only its technicians deputed to India, in the case of one project, stayed for more than 180 days. Nothing was brought on record to show that the technicians were operating from a fixed place in the custody of the taxpayer.
- The Tribunal observed that a literal reading of Article 5(2)(i) of the tax treaty indicates that supervisory activities by themselves cannot constitute a PE since the activities are required to be in connection with a building, construction or assembly activity of the non-resident, which is not the case here as the taxpayer provides only supervisory activities.
- Drawing support from the Klaus Vogel book (Third Edition), the Tribunal observed that though Article 5(2)(i) of the tax treaty talks about supervisory activities, it does not cover the instant case, as the taxpayer does not have any building site or construction site of its own. The activities being technical in nature would fall under FTS Article of the tax treaty.
- In order to apply Article 12(5) of the tax treaty, the taxpayer should have a PE, through which its activities are carried on. However, such a condition was not met in the present case. Therefore, Article 12(5) of the tax treaty does not apply to the taxpayer's case.
- Just because technicians stayed in India while supervising the work undertaken by the taxpayer, it cannot be said that their place of stay

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can be a 'fixed place of business' for the taxpayer. Had the AO examined the total period of deputing technicians to India and also examined whether there was an establishment where the taxpayer had any 'permanent place' to supervise the activities, then, the issue could be examined in the light of service PE considerations. However, the AO only examined the issue of the stay of technicians in India, which cannot be considered for examining the PE of the taxpayer in its supervising work.

- Thus the Tribunal held that the taxpayer's supervisory activities did not constitute a PE in India under the Act, as well as under Article 5 of the tax treaty. The taxpayer should be assessed for its supervisory activities as FTS under Article 12 of the tax treaty.
- With regards to the issue of whether the period of supervisory activities did not exceed a period of six months in all projects and if such projects of the taxpayer constituted a PE, the Tribunal did not adjudicate on that ground as it was already held that supervisory activities have to be in connection with the taxpayers' 'building site, construction or assembly project. Since it was already held that the receipts were in the nature of FTS and not in the nature of business income, the Tribunal did not deal with this issue.
- The Tribunal, however noted that it was incorrect to aggregate all contracts of the foreign company in India and consider it as one. Unless otherwise linked with each other, contracts should be individually assessed with respect to the duration test. This ratio is supported by the decision of the Mumbai Tribunal in the case of Valentine Maritime (Mauritius) Ltd.³².

60. GE Energy Parts Inc. v. ADIT [2014] 33 ITR(T) 411 (Del)

The GE group was engaged in various sales activities in India, for which the business heads were generally expats, who were appointed to head Indian operations. These expats were on the payroll of GE International Inc. (GEII), but working for various businesses of the GE Group. In accordance with the permission obtained from the RBI, a LO was set-up to act as a communication channel between the HO and the customers in India.

³² ADIT v. Valentine Maritime (Mauritius) Ltd. (ITA No.1532/Mum/05 dated 5 April 2010)

During the year under consideration, a survey³³ was conducted at the LO of GE International Operations Company Inc. (GEIOC). The survey indicated that the LO, instead of undertaking the permitted activities, was employing various persons and providing the services of such persons to the GE group entities worldwide. The activities indicated that the GEIOC was carrying out business in India through a PE and the income attributable to such PE was taxable in India.

The AO held that for AY 2002-03 to 2006-07 these expats had a fixed place of business in the form of LO in India. The activities of the non-resident GE group entities being conducted through LO were not of the preparatory or auxiliary character, but constituted a PE.

Tribunal's ruling

- Merely because the LinkedIn profiles were available in the public domain and were not referred by the AO, the tax department cannot be prevented from bringing that information on record, so as to arrive at the correct factual finding on the issue regarding a PE.
- The taxpayer cannot be permitted to first open the investigations/inquiries by not furnishing the necessary information and then claim benefit out of the same. It is the determination of correct taxability of the taxpayer, which should guide the proper course of action.
- It is true that either party cannot make out a new case by implanting additional evidence. However, where the additional evidence only supplements the information on the basis of which a factual finding is to be arrived at, and not supercede the information, then the Tribunal can and should look into those details.
- In the present case, it has been observed that LinkedIn profiles, sought to be filed by the tax department, has considerable bearing on the subject matter of appeal and therefore, it should be admitted. The taxpayer is free to rebut the information contained in the LinkedIn profiles by bringing on record contrary facts to dislodge the claims made in therein.
- The LinkedIn profiles were not in the nature of hearsay because it is

³³ Section 133A of the Act

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the employee who himself had given all the relevant details and the same relate to him. These details are akin to admission made by a person. No third party was involved in creating the LinkedIn profiles and, therefore, it cannot be said to be hearsay evidence.

- It is well settled law that admission, though not conclusive, is binding and decisive on point unless it is successfully withdrawn or proved to be erroneous³⁴. The LinkedIn profiles are in the nature of admissions of persons on their job profile since the data is in public domain.
- The strict Rules of Evidence are not applicable to income-tax proceedings. The evidences sought to be filed by the tax department were only supporting in nature and would assist in appreciating the facts in a more judicial manner.
- In view of above discussion, the Tribunal admitted the LinkedIn profiles filed by the tax department. However, in its interim order, the Tribunal has not concluded on the existence of the PE.

61. Consulting Engineering Corporation v. JDIT (I.T.A.No.1597/Del/2009)

Permanent establishment

The taxpayer had a branch in India which was engaged in providing various services to taxpayer viz. engineering, calculations as well as drawing of various architectural designs. Further 95 qualified employees were working in the Indian branch office for the associated enterprises based in the US. The AO held that the taxpayer had a fixed place of business in India, in the form of branch office, through which the business of the taxpayer was partly carried out and therefore, in terms of Article 5(2)(c) of the tax treaty, the taxpayer had a PE in India.

Tribunal's ruling

- The branch office represents a fixed place of business of the taxpayer through which substantial work was carried out by the taxpayer, which constitutes PE of the taxpayer in terms of Article 5(2)(b) and (c) of the tax treaty.
- As per the letter submitted by the taxpayer to CIT(A), the Indian

³⁴ Narayan v. Gopal AIR 1960 SC 100

branch's role was mainly towards engineering calculation and drafting which was as per direction, instruction and guidelines provided by the U.S. team. The Indian branch was primarily engaged in back end jobs and working under total control, superintendence and direction of the taxpayer.

- The branch was doing R&D work for the taxpayer and the same was being done exclusively which was the core business of the taxpayer. This important facet of the Indian branch's work was not of preparatory or auxiliary nature within the ambit of Article 5(3)(e) of the tax treaty. Accordingly, the Indian branch cannot be excluded from being a PE.
- The taxpayer in the present case minimises their cost of services and other expenditure by assigning and appointing highly technical and materially skilled professionals to discharge its main function in India at low cost. Accordingly, the taxpayer had a PE in India under Article 5(2)(b) and (c) of the tax treaty.

Attribution of income

As per the transfer pricing analysis report, the taxpayer had adopted the mark-up to the cost at 1.83 per cent whereas the AO found that the net profit earned by the taxpayer in its tax return filed in USA was 8.5 per cent and 10.6 per cent for relevant years which was based on sales.

Tribunal's ruling

- The work from the stage of discussion and obtaining the contract till its final marketing to the respective client has been undertaken by the taxpayer. However, the branch office contributed towards all development activities at cheaper cost of service and human resources in comparison to that in USA. Therefore, in comparison to USA comparable companies, as adopted in transfer pricing study, the taxpayer earned higher profit due to low cost of services and human input by the Indian PE.
- Although the risk factor was also borne by the Indian PE branch, certain risk in regard to capital investment, bad debts and other legal obligations were borne by the taxpayer.
- The CIT(A) had considered the fact that the Indian branch had taken some risks, as the important drawing and designing calculations are carried out by the Indian branch and impliedly other risks as stated above were borne by the taxpayer.

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- Therefore, in the facts and circumstances, the CIT(A) was justified in holding that 50 per cent of the profits determined by the AO (on global profit rate) after applying Rule 10 were to be attributable to the operations carried out by the PE in India.

Status of the taxpayer

The tax department adopted the status of the taxpayer as a company. However, the taxpayer was of the view that it should be considered as an individual instead of a foreign company because the taxpayer is a firm and not a company even in USA, since it is 100 per cent owned by a single individual.

Tribunal's ruling

While determining the status of the taxpayer, the provisions of the Act have to be applied. As per the provisions of the Act, any 'body corporate' incorporated by or under the laws of any country outside India has to be treated as a company. Accordingly, the taxpayer has to be treated as a foreign company for the tax purposes.

62. Morgan Stanley International Incorporated v. DIT (ITA No.6882/Mum/2011) (Mum)

The taxpayer company is a resident of USA and is a 100 percent subsidiary of M/s Morgan Stanley USA. The taxpayer's primary activity was to provide support services to various subsidiaries all over the world including India. In the relevant previous year, the taxpayer had entered into an agreement with M/s J M Morgan Stanley Securities Private Limited, an Indian Company for providing support services.

The taxpayer had deputed five of its employees in terms of the deputation letter. These employees were seconded to India to render their services to the Indian companies under supervision and control of the Board of Directors of the Indian companies and their day to day responsibility and activities were managed by the Indian company. The seconded employee's salary was paid by the taxpayer company after deducting tax under Section 192 of the Act and duly deposited into the account of Indian Government. The entire salary paid by the taxpayer has been reimbursed by the Indian company.

Tribunal's ruling

Service PE

- Applying the ratio laid down by the Delhi High Court³⁵ in the present case, it had to be seen, whether overseas entity i.e. the taxpayer, was the real economic employer of the seconded employees i.e. the employees are maintaining their lien on employment with the original overseas entity and whether the taxpayer remains responsible for the work of seconded employees in India or not.
- In the present case, the Tribunal proceeded on the premise that the seconded employees are the real employees of the taxpayer who had come to India to render services and therefore, they constitute Service PE in India. Such an establishment of PE under these circumstances has been dealt by the Supreme Court in the case of Morgan Stanley & Co³⁶ wherein it was held that the secondment of the employees of overseas entities to the Indian entity constitutes service PE in India. Based on this decision, it was clear that such deputed employees if continued to be on pay rolls of overseas entities or they continue to have their lien with jobs with overseas entities and were rendering their services in India, Service PE will emerge.
- Consequently, the seconded employees or deputed employees working in India for the Indian entity constituted a Service PE in India.

Fees for Included Service or Business Profit

- Article 12(6) of the tax treaty makes it clear that taxability of royalty and FIS shall not apply, if the resident of the contracting state (USA) carries on the business in other contracting state (India) in which FIS arises through PE situated therein, then in such case the provisions of Article 7 i.e. 'Business Profits' shall apply.
- If the taxability of such payment has to be examined and determined on the basis of computation of business profit under Article 7, then the salary paid by the taxpayer would amount to cost to the taxpayer, which is to be allowed as deduction while computing the business profit of the PE in India.

³⁵ Centrica India Offshore (P.) Ltd. v. CIT [2014] 364 ITR 336 (Del)

³⁶ DIT (IT) v. Morgan Stanley & Co. [2007] 292 ITR 416 (SC)

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- Accordingly, the ratio laid down in the decision of Delhi High Court in the case of Centrica India Offshore (P.) Ltd., will not help the case of the tax department, in any manner because under the concept of PE, FIS cannot be taxed under Article 12, but only as a business profit under Article 7. Similar provision is also embodied in Article 12(6) of the India-Canada tax treaty but this issue was neither raised nor brought to the notice before the Delhi High Court nor it was contested by either parties.
- There is an inherent contradiction in this concept, as in most of the treaties, exclusionary clause like Article 12(6) has been embodied, which makes the issue of taxability of FTS/FIS in such cases as non-applicable, and have to be viewed from the angle of Article 7.
- Accordingly, the decision of the Delhi High Court and all other decisions relied upon by the revenue will not apply in the case of the taxpayer, as nowhere the concept of Article 12(6) have been taken into account for determining the taxability of such a payment under the provisions of tax treaty.
- The payment made by the Indian entity to the taxpayer on account of reimbursement of salary cost of the seconded employees will have to be examined under Article 7 only. While computing the profits under Article 7, payment received by the taxpayer is to be treated as revenue receipt and any cost incurred has to be allowed as deduction because salary is a cost to the taxpayer which is to be allowed.
- Accordingly, the AO was directed to compute the payment strictly under terms of Article 7 and not under Article 12 of the tax treaty.

63. Forbes Container Line Pte. Ltd. v. ADIT (ITA No.1607/Mum/2014)

The taxpayer, a Singapore based company, engaged in the business of operating ships in international traffic across Asia and the Middle East. It is a wholly owned subsidiary of Forbes and Co. Ltd. (FCL), a company incorporated in India. FCL had entered into an agency agreement with Volkart Flemming Co. and Services Ltd. (VFSSL). VFSSL is a wholly owned subsidiary of FCL. VFSSL had demerged its shipping agency division into FCL with effect from 1 April 2008. The AO held that income of the taxpayer was arising out of operation of ships in international traffic and it was taxable in India as per the provisions of Section 5(2) of the Act read with the provisions of Section 44B of the Act. Further, the taxpayer had a PE in India

under Article 5 of the India-Singapore tax treaty (tax treaty), the income was taxable under Article 7 of the tax treaty. The CIT(A) upheld the order of the AO.

The Tribunal observed that:

On a reference to the e-mails placed by the taxpayer, it indicates that business activities were carried out by the Singapore office. Factors like staying off one of the directors in India or holding of only one meeting during the year under consideration or the location of the parent company in India in themselves would not decide the residential status of the taxpayer. The taxpayer had received a substantial portion of its income from the operation carried out in the Middle East and other countries. It was handling its business from Singapore. On a perusal of details of income of the parent company, it indicates that the claim made by the taxpayer about earning substantial income from the entities other than the holding company, was factually correct.

The taxpayer had not claimed exemption under Article 8 of the tax treaty as it was not engaged in the shipping business. Therefore, the income of the taxpayer had to be assessed under the provisions of the tax treaty which deals with business income (Article 7). The taxpayer did not own or charter or take on lease any vessel or ship for the year under consideration, it was only providing container services to various clients. Therefore, provisions of Section 44B of the Act were not applicable to the facts of the present case. Accordingly, the income of the taxpayer was liable to be taxed as business income and in the absence of a PE, no income was taxable in India.

64. DCIT v. Vertex Customer Management Ltd. [2016] 67 taxmann.com 105 (Del)

The taxpayer, a UK based company, is engaged in outsourcing services for its clients in finance, utility and the public sector. The main services provided by the taxpayer are customer management outsourcing business, service outsourcing and transfer of technology. Vertex Customer Service India Pvt. Ltd (Vertex India) is an Indian entity in the group, which also carries out outsourced work from the taxpayer. The outsource work is in relation to contracts of the taxpayer with PowerGen Retail Ltd. and Last Minute Networks Ltd. The taxpayer allowed Vertex India, the right to use certain equipment located outside India and claimed reimbursement of expenses incurred on behalf of Vertex India. The taxpayer offered the payment

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received from Vertex India for the right to use equipment outside India as royalty under Article 13(3)(b) of the tax treaty. Regarding the reimbursement, it was claimed that the same was not taxable as it was on a cost to cost basis. The AO held that the taxpayer has a PE in India under the tax treaty as well as a business connection under the Act and hence computed the profit attributable to such a PE. Regarding reimbursement as it has the effect of reducing the service fee payable to the Indian company was also considered as business profits of the PE in India. Further, royalty was also taxed as a business profit of the PE in India.

Tribunal ruling

Business connection

The term 'business connection' has not been defined under the Act. The Bombay High Court in the case of Blue Star Engg. Co. (Bom) (P) Ltd³⁷ and in the case of National Mutual Life Association of Australia³⁸ has laid down the principles of business connection. There are various factors, which need to be looked at while determining whether a business connection exists in a particular situation, or not. On perusal of various decisions, it is required to test the business connection principle with respect to continuity, real and intimate connection, attribution of income and common control and professional connection. The connection of the taxpayer with the Indian entity is continuous in order to have a business connection. There must be a real and intimate connection between the activity carried on by the non-resident outside India with the activity carried out in India. Further, such activity must be one, which contributes to the earnings of profits by the non-resident in his/her business. It is also a settled principle that to conform with the requirements of the expression 'business connection', it is necessary that a common thread of mutual interest must run through the fabric of the trading activity carried on outside as well as inside India and the same can be described as a real and intimate connection.

The commonness of interest may be by way of management or financial control or by way of sharing of profits. It may come into existence in some other manner, but there must be something more than the mere transaction of purchase and sale between 'principal to principal' in orders to bring the

³⁷ Blue Star Engg. Co. (Bom) (P) Ltd v. CIT [1969] 73 ITR 283 (Bom)

³⁸ CIT v. National Mutual Life Association of Australia [1933] I ITR 350 (Bom)

transaction within the purview of business connection. Further, where the Indian and the non-resident entity are both held by the same person or have common control, then the non-resident would be regarded as having a business connection in India. In this case, the taxpayer secures orders on behalf of the Indian company and outsources the job to the Indian company.

There is a continuous relationship between the taxpayer and its affiliates and its subsidiary company in India. The contract entered into by the taxpayer and its affiliates outside India is carried out in India. The responsibility of the taxpayer vis-a-vis, its customer, is concluded in India. The responsibility of the taxpayer cannot be segregated and will not be complete unless the Indian company provides services to the customers. Accordingly, the taxpayer had a business connection in India under Section 9(1)(i) of the Act.

Fixed place PE

For establishing the fixed place PE test, certain conditions should be satisfied cumulatively i.e. there is a place of business (place of business test), such a place of business is at the disposal of the taxpayer (disposal test), such a place of business is fixed (permanence test) and that the business of the entity is carried on wholly or partly through such a fixed place of business (activity test). In the present case, the taxpayer satisfies the place of business test, since Vertex India is the taxpayer's place of business. However, whether those premises are at the disposal of the taxpayer or not is an important parameter to constitute a PE. It is not necessary that the premises need to be owned or even rented by the enterprise.

The premises should be at the disposal of the enterprise. In the present case, it is not established that the premises were made available to a foreign enterprise. The space provided was not at the disposal of the

enterprise since it had no right to occupy the premises. Merely an access was given for the purpose of work, does not satisfy the disposal test. Relying on the Supreme Court's decision in the case of Morgan Stanley & Co Inc.³⁹ it was held that taxpayer does not have a fixed place PE in India.

Dependent agent PE

Agency replaces fixed place with a personal connection. Transactions between a foreign enterprise and an independent agent do not result in the

³⁹ Morgan Stanly

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establishment of a PE under Article 5 if the independent agent is acting in the ordinary course of their business. The expression 'ordinary course of their businesses' has reference to the activity of the agent tested by reference to the normal customs in the case to issue. It has reference to the normal practice in the line of business in question. However, as per Article 5(5) of the tax treaty, an agent is not considered to be an independent agent if his/her activities are wholly or mostly wholly on behalf of the foreign enterprise and the transactions between the two are not made under arm's length conditions. The twin conditions have to be satisfied to deny an agent the character of an independent agent. In case the transactions between an agent and the foreign principal are at an arm's length, the second stipulation of Article 5(5) would not be satisfied, even if the said agent is devoted wholly or almost wholly to the foreign enterprise. In view of the business model of the taxpayer and in the absence of material to suggest that the conditions mentioned in Article 5(4) of the tax treaty are satisfied, it was held that Vertex India does not constitute a dependent agent PE in India.

65. National Petroleum Construction Company v. DIT [2016] 66 taxmann.com 16 (Del)

The taxpayer is a company incorporated in the UAE, engaged in fabrication of petroleum platforms, pipelines and other equipment. The taxpayer undertakes contracts for installation of petroleum platforms, submarine pipelines and pipeline coating at various sites. In the course of its business, the taxpayer entered into contracts with ONGC for installation of petroleum platforms and submarine pipelines. The taxpayer computed its income on a presumptive basis by taxing the gross receipts pertaining to its activities in India less verifiable expenses at the rate of 10 per cent and the receipts pertaining to activities outside India at the rate of 1 per cent.

The AO held that the taxpayer had a fixed place PE in India. It was held that Arcadia Shipping Ltd. (ASL), a consultant, constituted a DAPE of the taxpayer in India. The AO held that the taxpayer also had an installation/construction PE in India. The AO held that the consideration received by the taxpayer for design and engineering was held to be FTS. The DRP and the Tribunal upheld the order of the AO.

High Court's ruling

Interplay of Article 5(1), 5(2) and 5(3) of the tax treaty

Normally an inclusive definition is used to expand the width of the term

sought to be defined. However, that does not appear to be the principal intent in drafting paragraph 2 of Article 5 of the tax treaty. Read in the context of the other provisions of Article 5, paragraph 2 clearly indicates that it has been used as an explanatory provision to specifically include the species of places of business that would constitute the PE of an enterprise. Article 5(1) and 5(2) of the tax treaty complement each other. Thus, all classes of PEs as specified in various subparas of paragraph 2 of Article 5 of the tax treaty would be construed as a PE subject to the essential conditions of paragraph 1 of Article 5 being met.

Insofar as sub-paras (h) and (i) of Article 5(2) of the tax treaty are concerned, the test of permanence as required under Article 5(1) of the tax treaty is substituted by a specified minimum period of nine months. Thus, places of business as specified under sub-paras (h) and (i) of Article 5(2) of the tax treaty cannot be construed as the PE of an enterprise, unless it exists for a period of atleast nine months. Paragraph 3 of Article 5 of the tax treaty is an exclusionary clause and is intended to exclude certain places of business from the scope of the expression PE. Paragraph 3 begins with a *non-obstante* clause. Thus, the exclusions provided under paragraph 3 would override the provisions of paragraph 1 and 2 of Article 5 of the tax treaty.

In other words, even if a place of business squarely falls within the definition of Article 5(1) and is specifically listed in 5(2) of the said Article, the same would, nonetheless, not be construed as the PE of an enterprise, if it falls within any of the exclusionary clauses contained in sub-paras (a) to (e) of paragraph 3 of Article 5 of the tax treaty. Thus, even though the taxpayer's PO established in India falls within the definition of PE in terms of paragraph 1 and 2 of Article 5 of tax treaty, it would still have to be seen whether it stands excluded under paragraph 3 of Article 5 of the tax treaty.

Article 5(4) of the tax treaty provides for a legal fiction to include an agent (other than an agent of an independent status) to be a PE of the principal enterprise. Paragraph 4 also begins with a *non-obstante* clause. Thus, even though an agent may not *stricto sensu* fall within the definition of a PE as defined under paragraph 1 and/or paragraph 2 of Article 5 of the tax treaty, yet it would be deemed that a PE of an enterprise exists if the business of an enterprise is carried out through an agent as described under Article 5(4) of the tax treaty. It is also not disputed that the taxpayer did carry out part of its business through its PO. In these circumstances, the conditions as spelt out in paragraph 1 and paragraph 2(c) of Article 5 of the tax treaty are satisfied.

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However, the matter does not rest here and it is required to be seen whether any of the exclusionary clauses of Article 5(3) of the tax treaty are applicable.

The language of Article 5(3)(e) of the tax treaty is similar to the language of Article 5(4)(e) of the Model Conventions framed by the OECD, United Nations as well as the U.S. The rationale for excluding a fixed place of business maintained solely for the purposes of carrying out an activity of a preparatory or auxiliary character has been explained by Professor Dr. Klaus Vogel. Further, the High Court relied on the decision of Morgan Stanley & Company Inc⁴⁰ and the UAE Exchange Centre Limited⁴¹.

The Black's Law Dictionary defines the word 'auxiliary' to mean as 'aiding or supporting, subsidiary'. The word 'auxiliary' owes its origin to the Latin word 'auxiliarius'. The Oxford Dictionary defines the word 'auxiliary' to mean 'providing supplementary or additional help and support'. In the context of Article 5(3)(e) of the tax treaty, the expression would necessarily mean carrying on activities, other than the main business functions, that aid and support the tax treaty. In the context of the contracts in question, where the main business is fabrication and installation of platforms, acting as a communication channel would clearly qualify as an activity of auxiliary character - an activity which aids and supports the taxpayer in carrying out its main business. In view of the above, the activity of the taxpayer's PO in India would clearly fall within the exclusionary clause of Article 5(3)(e) of the tax treaty and it cannot be construed as a PE in India.

Installation PE

It is necessary to understand that a building site or a construction assembly project does not necessarily require an attendant office. The site or the attendant office in respect of the site/project itself would constitute a fixed place of business once the taxpayer commences work at site. Thus, in order to apply Article 5(2)(h) of the tax treaty, it is essential that the work at site or the project commences. It is not relevant whether the work relates to planning or actual execution of construction works or assembly activities.

In the present case, the taxpayer claims that the survey was conducted by an independent third party and that too for a period of nine days in one instance and 27 days in another. The taxpayer commenced its activities at site when

⁴⁰ DIT vs Morgan Stanley & Company Inc[2007] 292 ITR 416 (SC)

⁴¹ UAE Exchange Centre Limited vs UOI [2009] 313 ITR 94 (Del)

the barges entered into the Indian Territory on 19 November 2006 and such activities relating to the installation, testing and commissioning of the platforms continued till 27 April 2007. Thus, the taxpayer's activity at site would indisputably commence on 19 November 2006 and continue till 20 April 2007, that is, for a period of less than nine months.

The initial activities at site were carried out by an independent subcontractor appointed by the taxpayer. If the commencement of the activities of the subcontractor is considered, the same commenced on 27 February 2006 and were concluded by 21 May 2006. An interruption in the normal course of activities such as a weekly day off would undoubtedly be included in the duration of the PE but in cases where the interruption exceeds substantial periods which represent cessation of the activities at site, it would be difficult to accept that the building/project site continues to represent the fixed place of business of an enterprise. A reference to the commentary by Klaus Vogel on Double Taxation Conventions on this aspect is also instructive.

In the facts of the present case, where the taxpayer did not have access to the site from the period starting 21 May 2006 till 19 November 2006, the same cannot be construed as its PE under Article 5(2)(h) of the tax treaty. If the period during which the taxpayer did not have access to the site in question is excluded, the aggregate period would be less than nine months and this would exclude the applicability of Article 5(2)(h) of tax treaty. In the facts, where an enterprise is not granted access to the site for a long duration and carries out no activity at the site during that period, the site could hardly be construed as the fixed place of business of a taxpayer during that period. In the present case, the installation activities lasted from 19 November 2006 till 27 April 2007, which is much less than the minimum period of nine months.

Even if the time spent by ASL in conducting the pre-engineering and predesign survey is included, the duration of the project activities in India would not exceed nine months. The taxpayer's PO is inextricably linked to the project. Therefore, if the duration of the project activities in India was less than nine months, it cannot be held that the taxpayer had a PE in India under Article 5(2)(h) of the tax treaty.

DAPE

The consultancy agreement did not fetter ASL to carry out its regular activities including providing consultancy services to persons other than the

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taxpayer's competitors. The financial accounts of ASL also clearly indicate that it had earned substantial income other than the remuneration received/receivable from the taxpayer. In view of the above, the Tribunal's conclusion that ASL was working 'wholly and exclusively' for the taxpayer, is clearly not sustainable. The consultancy agreement clearly indicates that ASL was engaged to (a) provide assistance in gathering relevant market information; (b) assistance in obtaining works; (c) active representation and promotion of the taxpayer's activities in India; and (d) provide assistance in obtaining services and facilities in India.

The consultancy agreement clearly indicates that the contracts would be tendered for and executed by the taxpayer. The taxpayer had also duly disclosed ASL to be its agent involved in the contract as well as the remuneration payable to ASL. The representatives of ASL were present at the pre-bid meeting held with ONGC as well as at the kick-off meeting. The presence of ASL at such a meeting was clearly in pursuance of the services agreed to be rendered by them. However, this by itself cannot lead to an inference that ASL constituted a DAPE of the taxpayer in India.

It is also apparent from the final accounts of ASL for the year 2006-07 that it carries on substantial business other than the services provided to the taxpayer. The agreement entered into between the taxpayer and ASL is also on a principal-to-principal basis. Even otherwise, there is material to support the view that the taxpayer would bid and execute contracts in its name. The consultancy agreement does not authorise ASL to conclude contracts on behalf of the taxpayer. Although, the correspondence between the taxpayer and ASL indicated that ASL was involved in the project since the pre-bid meeting and had also acted on behalf of the taxpayer, it cannot be concluded that ASL was habitually authorised to conclude contracts on behalf of the taxpayer. In view of the above, ASL cannot but be considered as an agent of independent status to whom Article 5(5) of the tax treaty applies. In this view, ASL would not constitute a DAPE of the taxpayer in India. In view of conclusion that the taxpayer did not have a PE in India, the question of attributing any income of the taxpayer to the PE does not arise.

Taxability of incomes attributable to design, procurement of material and fabrication of platforms

On perusal of Article 7 of the tax treaty it indicates that only such income as is attributable to the taxpayer's PE in India can be taxed. In Hyundai Heavy

Industries⁴² the Supreme Court had explained that the only way to ascertain the profits arising in India would be by treating the taxpayer's PE in India as a separate profit centre viz-a-viz its foreign enterprise. In the present case, the consideration of various activities has been specified in the contracts. The contract price schedule and rental rates schedule specifically assign values to various activities. It is also not disputed that the invoices raised by the taxpayer specifically mention the work done outside as well as in India.

Thus, even though the contracts may be turnkey contracts, the value of the work done outside India is ascertainable. There is no dispute that the values ascribed to the activities under the contracts are not at arm's length. There is also no material evidence to indicate that the work done outside India included any input from the taxpayer's PE in India. The Tribunal had considered the contract and in view of the fact that the consideration for various activities such as design and engineering, material procurement, fabrication, transportation, installation and commissioning had been separately specified, the Tribunal rightly held that the consideration for the activities carried out overseas could not be attributed to the taxpayer's PE in India.

In view of the conclusion that the taxpayer did not have a PE in India during the Assessment Years (AYs) 2007-08 and 2008-09, no income of the taxpayer from the projects in question can be attributed to the taxpayer's PE.

SLP granted in case *DIT vs. National Petroleum Construction Co. (2016) 242 Taxman 250 (SC)*.

66. CIT v. Bank of India [2015] 64 taxmann.com 215 (Bom)

The taxpayer had sought relief in respect of the profit earned by the foreign branches on the basis of respective tax treaties. The AO granted a benefit in respect of the branches at Singapore and Japan but denied the benefit to the taxpayer in respect of the other branches. The CIT(A) allowed the taxpayer's claim. The Tribunal dealt with a question of whether income earned from foreign branches would be taxable in India. The Tribunal held that in the case of all the foreign countries, the operations were carried out through its branches which is a PE situated outside India. Therefore, the income attributable to these branches cannot be taxed in India. The Tribunal

⁴² CIT & Anr. vs Hyundai Heavy Industries [2007] 291 ITR 482 (SC)

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followed its earlier ruling⁴³ where on perusal of Articles 23, 24 and 25 of the relevant tax treaties, it was held that the laws in force in either of the contracting states would govern the taxation of income in the respective contracting states i.e. credit of tax paid in one state would be given in the other state.

Bombay High Court's ruling

The AO was satisfied that the benefit of the tax treaty is admissible, provided the proof is produced in relation to the payment of taxes by the taxpayer abroad. If the taxpayer has a PE abroad, then, the taxpayer would have to produce evidence regarding payment of taxes pertaining to the income of these establishments abroad. On production of such evidence, the taxpayer would then be entitled to the benefit. The evidence was always available as noted by the CIT(A) and the Tribunal. The tax authorities followed their earlier orders based on identical facts and circumstances. Therefore, it cannot be termed as perverse or vitiated by any error of law apparent on the record.

67. Swiss Re-insurance Company Limited v. DDIT [2015] 55 taxmann.com 520 (Mum)

The taxpayer is a company incorporated in Switzerland and it receives income from providing reinsurance services to various cedants in India. The re-insurance premium received by the taxpayer is claimed as business income and it is further claimed that in absence of any PE in India the entire business income is not taxable in India. The taxpayer through its Singapore branch has entered into a service agreement with its wholly owned subsidiary in India for obtaining risk assessment services, market insurance and administrative support in India. The taxpayer remunerates/compensates the Indian subsidiary on a cost plus 12 per cent margin. The AO was of the opinion that since the taxpayer has remunerated the Indian subsidiary and all its employees on a cost plus basis, it is clear that the personnel and staff have rendered services to the taxpayer as de-facto employees. The AO also observed that the Indian subsidiary provides technical and core reinsurance services and, therefore, DAPE comes into play. The AO treated the Indian subsidiary not only as a Service PE of the taxpayer but also as agency PE. The AO also held that since the income of the taxpayer being earned from

⁴³ (ITA No. 1679/Mum/2001, dated 27 March 2008)

India is on a regular and continuous basis, the income of the taxpayer is taxable in India under Section 9(1)(i) of the Act. The Dispute Resolution Panel (DRP) upheld the order of the AO.

Tribunal ruling

On a perusal of Explanation 2⁴⁴ to Section 9(1) of the Act it indicates that none of the conditions specified in clause (a) (b) and (c) of the Explanation are satisfied in the present case. Therefore, it cannot be said that the taxpayer was having any business connection in India. Even if PE conditions provided under Article 5(2)(l)⁴⁵ are fulfilled, we did not find that the employees of the subsidiary company are providing services to the taxpayer as if they were the employees of the taxpayer. Therefore, conditions laid down under Article 5 of the tax treaty are not fulfilled to treat the Indian subsidiary as PE of the taxpayer. On a perusal of Article 5(4) of the tax treaty, it indicates that reinsurance has been specifically excluded by the tax treaty. Considering the services rendered by the Indian subsidiary in the light of the OECD commentary, the Indian subsidiary company cannot be considered as PE of the taxpayer. The decision relied upon by the tax department was not applicable to the facts of the present case.

In the case of Motorola Inc.⁴⁶ the employees of the taxpayer had worked both

⁴⁴ The term business connection shall include any business activity carried out through a person who, acting on behalf of the non-resident who:

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident

⁴⁵ The furnishing of technical services, other than services as defined in Article 12, within a Contracting State by an enterprise through employees or other personnel, but only if :-

(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve month period; or

(ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9) for a period or periods aggregating more than 30 days within any twelve-month period.

⁴⁶ Motorola Inc. v. DCIT [2005] 95 ITD 269 (Del)

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for the taxpayer as well as its Indian subsidiary. The employees also had the right to enter the office of the Indian subsidiary either for the purpose of working for the Indian subsidiary or for the purpose of working for the taxpayer. Further, the Indian subsidiary provided perquisite to the employees of the taxpayer and the taxpayer paid salaries to the employees. However, perusal of the facts of the present case indicate that the employees of the Indian subsidiary only provided services to Indian subsidiary and there was no record to prove that the employees had provided services to the taxpayer or the taxpayer is paying their salaries or perquisites.

The decision of the Supreme Court in the case of Morgan Stanley⁴⁷ has been duly considered by the Delhi High Court in the case of E-Funds IT Solutions⁴⁸. Further, the decision of the Karnataka High Court in the case of Jebon Corporation⁴⁹ was not applicable to the facts of the present case. Accordingly, it has been held that the taxpayer does not have any business connection in India in the light of Explanation 2 to Section 9(1) of the Act. Further, the taxpayer does not have Service PE or Agency PE in India.

68. B.J. Services Company Middle East Limited v. ACIT [2015] 60 taxmann.com 246 (Utt)

The taxpayer, a non-resident company, is engaged in the business of oil exploration. During the year under consideration, the taxpayer received interest on income tax refund. The taxpayer computed tax on such tax refund at the rate of 15 per cent under Article 12 of the tax treaty relating with interest income. However, the Assessing Officer (AO) treated such interest as business income and assessed that under Article 12(6) of the tax treaty as the taxpayer was having Permanent Establishment (PE) in India. The Commissioner of Income-tax (Appeal) [CIT(A)] and the Tribunal upheld the order of the AO.

The High Court held that the interest earned on income tax refund is taxable as business income under the India-UK tax treaty since the debt claim in respect of which interest paid is effectively connected with a PE in India.

The High Court has also held that Section 44BB of the Act was not applicable to interest on income tax refund since the amount of such interest

⁴⁷ DTR v. Morgan Stanley & Company [2007] 292 ITR 416 (SC)

⁴⁸ DIT v. E-Funds IT Solutions [2014] 42 Taxman 50 (Del)

⁴⁹ Jebon Corporation India v. CIT [2011] 245 CTR 300 (Kar)

was not on account of the provision of services and facilities in connection with, or supply of plant and machinery on hire in the prospecting for, or extraction or production of mineral oils.

69. Reuters Limited v. DCIT [2015] 63 taxmann.com 115 (Mum)

The taxpayer is a resident of U.K. engaged in the business of providing worldwide news and financial information products. The taxpayer produces, compiles and distributes the news and financial information products through 'Reuters Global Network' with a vast global communication network. The taxpayer uses the network to receive and transmit information and provide access of the compiled news and edited financial information to distributors in the various countries. In India, the taxpayer provides 'Reuters products' to its Indian subsidiary named as Reuters India Private Limited (RIPL) under certain specified agreements. In turn, the RIPL distributes the 'Reuters products' to the Indian subscribers independently in its own name. The taxpayer entered into a distributor agreement with the RIPL as per which the RIPL has been appointed as distributor to sell designated 'Reuters Products' to subscribers in India using the Reuters Global Network. During the relevant year the taxpayer had deputed its employee, Mr. Simon Cameron Moore, as News Bureau Chief (NBC) of Mumbai for gathering, writing and distributing the news and overall coverage of news.

In terms of the distributor agreement, the taxpayer had received distribution fees which was claimed to be not taxable in India in the absence of PE. The AO held that revenue earned by the taxpayer was taxable as FTS under Article 13 of the tax treaty. It was further held that RIPL constituted dependent agent PE in India under Article 5(5) of the tax treaty and therefore, income was taxable under Section 44D of the Act on the gross basis. The DRP held that the taxpayer had a PE in India in the form of RIPL, as it was dedicated for the business of the taxpayer. Further, Mr. Simon Cameron Moore was deployed in India as NBC during the relevant period, for rendering service to RIPL on taxpayer's behalf and such services will constitute service PE in India.

Tribunal's ruling

Agency PE

On reference to the relevant terms of the distribution agreement, it indicates that nowhere it has been specified or there is any mandate that RIPL was habitually exercising its authority to negotiate and to conclude the contracts

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on behalf of the taxpayer in the territory of India which is binding or can bind the taxpayer. It envisages simply delivering of Reuter services for a price which can be further distributed by the RIPL for earning of its own revenue. There was no clause in the agreement that RIPL will act as an agent on behalf of taxpayer *qua* the distribution to subscribers. In fact, the RIPL is having independent contract with the subscribers, which is evident from the contract agreement between RIPL and third party subscribers in India. Similarly, when RIPL is supplying news and material to the taxpayer, the same is again on principal-to-principal basis. The second condition as mentioned in Article 5(4) of the tax treaty also does not fulfill, because RIPL is not habitually maintaining stock of any goods and merchandise for which it can be held that it is regularly delivering goods on behalf of the taxpayer. Lastly, it is not habitually securing the orders wholly and almost wholly for the taxpayer.

Even under Article 5(5) of the tax treaty, the activities of RIPL cannot be said to be devoted wholly or almost wholly on behalf of the taxpayer as it had entered into contracts with the subscribers in India on independent basis and on principal-to-principal for earning and generating its revenues. In fact revenue from third party subscribers was far excess than transaction with the taxpayer. In the present case it was not the case that the RIPL was completely or wholly doing activity for the taxpayer and earning income wholly from taxpayer only. Thus, the conditions laid down in Article 5(5) of the tax treaty also do not fulfill.

Service PE

There was no furnishing of services by the NBC to the RIPL which had led to earning of a distribution fee to the taxpayer. As per terms of the agreement, the taxpayer was merely delivering Reuters services to the distributors. The NBC has nothing to do for providing of Reuters services to the distributor. The NBC was only acting as a chief reporter and text correspondent in India in the field of collection and dissemination of news. Thus, it cannot be held that the NBC constitute a service PE in India for the taxpayer under Article 5(2)(k) of the tax treaty as he has not furnished any services in India on which the taxpayer has earned the distribution fee.

70. Food World Supermarkets Ltd v. DDIT [2015] 63 taxmann.com 43 (Bang)

The taxpayer is an Indian company engaged in the business of ownership and operation of a supermarket chain in India. The taxpayer entered into an

agreement with Diary Farm Company Ltd. (DFCL), a Hong Kong based company, engaged in the identical business activity as that of the taxpayer. In terms of the said agreement, DFCL agreed to assign its employees to the taxpayer and consequently five employees/ expatriates were deputed. The taxpayer agreed to engage these employees to assist it in its business operation. It was also agreed between the parties that the salary to their assigned personnel would be paid by DFCL, which was subject to Tax Deduction at Source (TDS) under Section 192 of the Act. The taxpayer reimbursed DFCL towards the salary paid to the assigned personnel without deduction of tax at source. The Assessing Officer (AO) held that a remittance made by the taxpayer constitutes as FTS under Section 9(1) (vii) of the Act. The same is chargeable to tax on a gross basis. Therefore, the taxpayer was liable to deduct tax under Section 195 at 10 per cent. Accordingly, the AO treated the taxpayer as 'an assessee in default' under Section 201(1) of the Act for not withholding tax at source. The AO also determined the interest under Section 201(1A) of the Act. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal ruling

Taxability as FTS under the Act

On referring the details of the seconded employees in the agreement, it indicates that all five secondees were not ordinary employees or workers but they were deputed on high level managerial/executive positions, which indicates that they were deputed because of their expertise and managerial skills in the field. The secondment agreement was between the taxpayer and DFCL, and the secondees assigned to the taxpayer were not a party to the agreement. Further, the secondees were assigned by DFCL and there was no separate contract of employment between the taxpayer and the secondees. The secondees were under the legal obligation as well as employment of DFCL and assigned to the taxpayer only for a short period of time. In the absence of any contract between the taxpayer and the secondees, the parties cannot enforce any right or obligation against each other. The secondees can claim their salary only from the parent company and not from the taxpayer. Thus, the expatriates were performing their duties for and on behalf of DFCL. Once it was found that the secondees were rendering managerial and highly expertise services to the taxpayer, the payment for such services would fall under the ambit of FTS as defined in Explanation 2 to Section 9(1)(vii) of the Act. An identical issue has been

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considered and decided by the Delhi High Court in the case of Centrica India Pvt. Ltd. v. CIT [2014] 364 ITR 336 (Del). Subsequently, the Special Leave Petition (SLP) filed against the decision of the Delhi High Court has been dismissed by the Supreme Court in Centrica India Pvt. Ltd. v. CIT [2014] 227 Taxman 368 (SC). Therefore, the view taken by the High Court has attained finality.

The concept of income includes positive as well as negative income or nil income. In the case of payment being Fees for Technical Services (FTS) or royalty as per Section 9(1) of the Act, it is irrelevant whether any profit element is included in the income or not. It is not only a matter of computation of total income when the concept of profit element in the payment is relevant. If the payment being FTS or royalty is made to a non-resident, then the concept of total income becomes irrelevant and the provisions of Section 44DA of the Act recognise the gross payment chargeable to tax. Thus, all the payments made by the taxpayer to a non-resident on account of FTS or royalty is chargeable to tax irrespective of any profit element in the said payment or not. However, there is an exception to this rule of charging the gross amount when the non-resident is having a fixed place of business or /Permanent Establishment (PE) in India and the amount is earned through the PE, then the expenditure incurred in relation to the PE for earning the said amount is allowable as per the provisions of Section 44DA of the Act. Therefore, in view of the decision of the Delhi High Court in the case of Centrica, the payment made to foreign company partakes the character of FTS as per the definition under Explanation 2 to Section 9(1)(vii) of the Act.

Service PE under the Act

The Tribunal observed that there is no tax treaty between India and Hong Kong and under the provisions of the Act, there is no concept of a service PE. Since there is no tax treaty between India and Hong Kong, the concept of a service PE requires a proper examination of all the relevant facts as well as provisions on the point whether it constitute a service PE in India or not. Accordingly, the issue was remitted to the file of the AO for adjudication of the issue of whether the secondment of employees constitute service PE.

71. NGC Network Asia LLC v. JDIT (ITA No. 7994/Mum/2011)

The taxpayer is a US based company and is a subsidiary of 'Fox Entertainment Group Inc'. It holds 100 per cent shares in NGC Network

(Mauritius) Holden Ltd, which in turn, holds 99 per cent shares in NGC Network (India) Private Limited (NGC India). The taxpayer is the owner of two television channels viz., The National Geographical Channel and Fox International Channel. It is engaged in the business of broadcasting of its channels in various countries including the Indian sub-continent. The taxpayer is eligible for the tax treaty benefit. The taxpayer appointed NGC India as its distributor to distribute its television channels and also to procure advertisements for telecasting in the channels. Hence, the taxpayer generates two streams of revenues from India, i.e. (a) Fee for giving distribution rights for telecasting of its channels and (b) Advertisement revenues.

During the assessment year (AY) 2007-08, two agreements entered by the taxpayer with NGC India in respect of advertisement revenues. As per the old agreement, the taxpayer has given commission at 15 per cent to NGC India and retained 85 per cent of the advertisement revenue. As per the new agreement, it has received fixed amount from NGC India for giving contract of procuring advertisements. The taxpayer claimed that both types of income were not taxable in India and accordingly did not offer them in the return of income filed for AY 2007-08. The AO held that the advertisement revenues as well as distribution revenues are taxable in India since NGC India is having a DAPE of the taxpayer under the tax treaty. The AO accordingly assessed 25.34 per cent of the advertisement revenues as income of the taxpayer attributable to India, i.e. in the ratio of worldwide profits to worldwide revenue, in accordance with Rule 10B(ii) of the Rules. The DRP upheld the order of the AO.

Tribunal's ruling

Dependent Agent PE

On a perusal of the various clauses of the new agreement, the Tribunal observed that NGC India habitually exercises in India an authority to conclude contracts on behalf of the taxpayer and the same is binding on the taxpayer since it has agreed to broadcast the advertisements procured by NGC India.

Hence, NGC India should be classified as 'dependent agent' of the taxpayer in terms of Article 5(4)(a) of the tax treaty. Accordingly, the taxpayer was having PE in India through its dependent agent NGC India in terms of Article 5(4)(a) of the treaty, since NGC India has been given full authority to conclude the contracts in India.

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Attributions of profits

The taxpayer contended that Transfer Pricing Officer (TPO) has held that since transaction entered into is at arms length price (ALP), no further attribution is necessary. Further, the taxpayer relied on various decisions⁵⁰. However, the decisions relied on by the taxpayer was distinguishable on the facts of the present case. The observations made by the Supreme Court in the case of Morgan Stanley shall apply where the payments made by the foreign company to the Indian company for the services availed by it.

Accordingly, the certification of ALP by the TPO and the decision of various courts would be applicable only in respect of the payments made by a foreign company to its Indian Associated Enterprise (AE) in respect of services availed by it. However, if the foreign company receives any money from the Indian soil and if it is held to be having a PE, then the taxability of the same have to be examined in accordance with the provisions of India-USA treaty as well as under the provisions of Income-tax Act, 1961 (the Act).

It has been observed that the taxpayer had contended before the AO that it is not taxable at all in respect of advertisement revenue and hence it has been observed that the taxpayer has not challenged the income worked out by the AO. Therefore, in the interest of natural justice, it has been held that the taxpayer should be provided an opportunity to submit its contentions with regard to the computation of income from advertisement revenues.

Accordingly, for this limited purpose, the issue has been restored to the file of the AO. If the taxpayer does not have to say anything in this regard, the income computed by the AO shall stand.

Taxability of Royalty

During the year under consideration, the taxpayer generated income through distribution rights of channels. The AO held that the revenue generated on granting of distribution rights was in the nature of royalty and accordingly assessed 15 per cent of thereof as income of the taxpayer under Article 12 of the tax treaty.

It has been observed that the AO has made a general observation that the Article 12 of the tax treaty shall be applicable without critically analyzing the

⁵⁰ DIT v. Morgan Stanley & Co. Inc. [2007] 292 ITR 416 (SC), DIT Vs. BBC Worldwide Ltd [2011] 203 Taxman 554 (Del), DIT v. B4U International Holdings Ltd [2015] 57 taxmann.com 146 (Bom)

provisions of the treaty. Though the AO has also referred to the provisions of Explanation 2 to Section 9(1)(vi) of the Act for examining the definition of the term 'royalty', yet the AO has not critically discussed its applicability to the impugned payment.

The definition of the term 'royalty' given in Section 9(1)(vi) of the Act as well as in the India-USA tax treaty uses the expression 'process'. The said expression has not been defined in the tax treaty, but the same has been defined in Explanation 6 to Section 9(1)(vi) of the Act.

The aforesaid Explanation has been inserted by the Finance Act, 2012. It had been observed that the various decisions relied upon by the taxpayer had been rendered before the insertion of the Explanation 6 or the applicability of the above said Explanation has not been examined therein. Hence, the question whether the payment received by the taxpayer for giving distribution rights shall fall in the category of 'royalty' needs to be examined afresh at the end of the AO.

Further, while dealing with the issue relating to the advertisement revenue, the High Court held that the taxpayer is having DAPE. The said fact also needs to be taken into account while examining the issue.

72. Formula One World Championship Ltd v. CIT [2017] 394 ITR 80 (SC)

The Supreme Court in the case of Formula One World Championship Ltd. dealt with the issue that whether the international circuit for formula one race constitutes a fixed place of business under the India-U.K. tax treaty. Further whether such international circuit was under the control and at the disposal of the taxpayer. The Supreme Court observed as follows:

- On a combined reading of Article 5(1), 5(2), 5(3) of the tax treaty, it indicates that only certain forms of establishment would not form a Permanent Establishment (PE) that are excluded in Article 5(3) of the tax treaty. Article 5(2) uses the word 'include' which means the list is not exhaustive and it may include the places which are not specified therein as PE. In order to bring any other establishment which is not specifically mentioned, the requirements laid down in Article 5(1) of the tax treaty are to be satisfied. Twin conditions which need to be satisfied are: (i) existence of a fixed place of business; and (ii) through that place of business an enterprise is wholly or partly carried out its business.

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- It cannot be denied, that Buddh International Circuit is a fixed place. From this circuit different races, including the Grand Prix is conducted, which is undoubtedly an economic/business activity.
- There cannot be any race without participating/competing teams, a circuit and a paddock. All these are controlled by the taxpayer and its affiliates. An event has taken place by conduct of race physically in India. Entire income is generated from the conduct of this event in India. Thus, commercial rights are with the taxpayer which are exploited with actual conduct of race in India.
- Even the physical control of the circuit was with the taxpayer and its affiliates from the inception, i.e. inclusion of event in a circuit till the conclusion of the event. Omnipresence of the taxpayer and its stamp over the event is loud, clear and firm.
- As per Philip Baker, a PE must have three characteristics: stability, productivity and dependence. All characteristics are present in the present case. Fixed place of business in the form of physical location, i.e. Buddh International Circuit, was at the disposal of the taxpayer through which it conducted business. Aesthetics of law and taxation jurisprudence leave no doubt that a taxable event has taken place in India and a non-resident taxpayer is liable to pay tax in India on the income earned.
- The Supreme Court rejected the taxpayer's contention that since the duration of the event was only three days, the total duration for which limited access was granted to it was not sufficient to constitute the degree of permanence necessary to establish a fixed place PE. The Supreme Court observed that the question of the PE has to be examined keeping in mind that the aforesaid race was to be conducted only for three days in a year and for the entire period of the race the control was with the taxpayer.
- Also rejected the taxpayer's contention that it was Jaypee who was responsible for conducting races and had complete control over the event and clarified that mere construction of track by Jaypee or its ownership or organising other events is immaterial.

73. ADIT v. E-Funds IT Solution Inc. [2017] 86 taxmann.com 240 (SC)

The taxpayers are companies incorporated in U.S. They were assessed and

have paid taxes on their global income in U.S. The taxpayers were engaged in the four businesses, namely, ATM management services, electronic payment management, decision support and risk management and global outsourcing and professional services. e-Fund India had performed back office operations in respect of the first three. Both the taxpayers have entered into international transactions with e-Fund India.

The Assessing Officer (AO) held that income of the two taxpayers were attributable to India because the two taxpayers had a PE in India and should be taxed in India, irrespective of whether the said taxpayers had paid taxes in U.S. Income earned and taxed in the hands of e-Fund India was different from the income attributable to the two taxpayers. Thus, the income attributable to the two taxpayers, which was not included in income earned and taxed in the hands of e-Fund India, should be taxed in India. The AO held that the taxpayers had a fixed place PE from where they carried on their own business in India. Consequently, the taxpayers were liable to pay tax in respect of what they earned from the aforesaid fixed place PE in India.

The Commissioner of Income-tax (Appeals) [CIT(A)] held that Article 5 of the tax treaty was attracted, not only because there was a fixed place business, but also because they were 'Service PEs' and 'Agency PEs' under Article 5 of the tax treaty. Subsequently, the Tribunal held that the CIT(A) was right in holding that a 'fixed place PE' and 'service PE' had been made out under Article 5 of the tax treaty. The High Court held in favour of the taxpayers. The High Court held that the Indian subsidiary does not create a fixed place PE under the tax treaty. Merely because the non-resident taxpayer to protect their interest, for ensuring quality and confidentiality has sent its employees to provide stewardship services, will not make the Indian subsidiary or another entity, a PE even if the employees of the non-resident taxpayer were taken on deputation. The High Court held that the activities, which were not undertaken by e-Fund India and the assets of the taxpayers located outside India, cannot be taken into account or attributed for earning/income of the taxpayers.

Supreme Court's decision

Fixed place PE

- There must exist a fixed place of business in India, which is at the disposal of the U.S. companies, through which they carry on their own business. In the present case there is, no specific finding in the

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assessment order or the appellate orders that applying the aforesaid tests, any fixed place of business has been put at the disposal of these companies.

- The High Court has dealt with this aspect in more detailed manner and held that the lower authorities have primarily relied upon the close association between e-Fund India and the taxpayer and applied functions performed, assets used and risk assumed (FAR) criteria to determine whether or not the taxpayer has fixed place of business. This is not a proper and appropriate test to determine the location PE. The allegation that e-Fund India did not bear sufficient risk is irrelevant when deciding whether location PE exists.
- Similarly, the High Court held that the direct or indirect costs and corporate allocations in software development centre or BPO does not help or determine location PE. Assignment or sub-contract to e-Fund India is not a factor or rule which is to be applied to determine applicability of Article 5(1) of the tax treaty. Subsidiary company will not become location PE under Article 5(1) merely because there is interaction or cross transactions between the Indian subsidiary and the foreign Principal under Article 5(1) of the tax treaty.
- No part of the main business and revenue earning activity of the two American companies is carried on through a fixed business place in India which has been put at their disposal. The Indian company only renders support services which enable the taxpayers in turn to render services to their clients abroad. This outsourcing of work to India would not give rise to a fixed place PE and the High Court decision is, therefore, correct on this score.

Service PE

- The Supreme Court observed that the requirement of Article 5(2)(l) of the tax treaty is that an enterprise must furnish services 'within India' through employees or other personnel. None of the customers of the taxpayer are located in India or have received any services in India. All its customers receive services only in locations outside India. Only auxiliary operations that facilitate such services are carried out in India. Therefore, it is clear that the first ingredient contained in Article 5(2)(l) is not satisfied. Therefore, the taxpayer did not have Service PE in India.

Agency PE

- Before the Supreme Court, the taxpayer argued that the 'agency PE' aspect of the case need not be gone into as it was given up before the Tribunal. The taxpayer is right as no argument on this score is found before the Tribunal. However, the Supreme Court observed that for the sake of completeness, it is only necessary to agree with the High Court, that it has never been the case of revenue that e-Funds India was authorized to or exercised any authority to conclude contracts on behalf of the US company, nor was any factual foundation laid to attract any of the said clauses contained in Article 5(4) of the tax treaty.

Profit attribution

- The Supreme Court in the case of Morgan Stanley held that the object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. Under Article 7(2) of the tax treaty, not all profits of foreign company would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India on so much of its business profit as is attributable to the PE in India. The Supreme Court held that once a transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE. If transfer pricing analysis does not adequately reflect the FAR by the enterprise, there would be a need to attribute profits to PE for those functions/risks that have not been considered.
- The taxpayer is correct in stating that as the arm's length principle has been satisfied in the present case, no further profits would be attributable even if there exists a PE in India.

MAP proceedings

- The taxpayer has referred to paragraph 3.6 of the Organisation for Economic Co-operation and Development (OECD) Manual on Mutual Agreement Procedure (MAP)⁵¹. A perusal of the same would indicate

⁵¹ OECD Manual on MAP Procedure provides that competent authority agreements or resolutions are often case and time specific. They are not considered precedents for either the taxpayer or the tax administrations in regard to adjustments or issues relating to subsequent years or for competent authority discussions on the same issues for other

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that a competent authority should engage in discussion with the other competent authority in a principled, fair and objective manner, with each case being decided on its own merits. The Supreme Court observed that where an agreement is not otherwise achievable, then both parties should look for appropriate opportunities for compromise in order to eliminate double taxation on the facts of the case, even though a principled approach is important.

- The High Court had held that the MAP procedure and agreement of earlier year is relevant but cannot be the primary basis to decide whether the taxpayer had PE in India. Whether or not PE exists is a matter of law and fact, and there has to be determination of the said issue on merits. The Supreme Court held that MAP cannot be considered as a precedent for subsequent years, and the High Court's conclusion on this aspect is correct.

74. *NetApp B. V. v. DDIT [2017] 78 taxmann.com 97 (Del)*

The taxpayer is a non-resident company engaged in the business of selling storage system equipments and products including embedded software and rendering certain services in India. The taxpayer sales NetApp products and services in India through third party distributors who are appointed on non-exclusive basis and they purchases NetApp products and services from the company on principal to principal basis and resale the same to customers or to other resellers. The taxpayer also provides services through Netapp India private limited, subsidiary of NetApp US company in terms of agreements entered with them by the taxpayer. The company also engages in direct sales contracts and the title of the goods passes directly to the customer to enable them to claim indirect taxes such as customs, etc. However, the distributor is responsible for the sale process. The taxpayer earns income in India from sale of storage products, sale of subscriptions and provision of support services. The taxpayer also provides installation, warranty and professional services with respect to data migration, data integration and disaster recovery services.

taxpayers. In fact, the letters exchanged between competent authorities to resolve a case often state as much. This is because the competent authorities have reached an agreement that often takes into account the facts of the particular taxpayer, the differences in the provisions of the tax law in each country, as well as the effects of the economic indicators on the particular transactions at the relevant time. Any review or adjustments of subsequent years by a taxpayer or tax administration is best based upon the particular circumstances, facts and documentary evidence existing for those years

The AO held that the taxpayer has a business connection in India under Section 9(1) of the Act. It was also held that the taxpayer has a PE in India under Article 5 of the India-Netherlands tax treaty because of existence of NetApp India. Payment received by the taxpayer towards licensing of the software are taxable as royalty and further this software payment are effectively connected with the PE in terms of Article 12 and 7 of the tax treaty, the same shall be chargeable to tax as business income in India. With regard to service fees on account of services rendered to its Indian clients, the AO was of the view that the services are predominately technical in nature and further, it is falling within the definition of royalty. It is also effectively connected to the PE of the taxpayer, therefore chargeable to tax under Article 7 of the tax treaty. The AO contended that part of the profits arising from payment towards hardware is also attributable to the activities of the PE in India. Accordingly, attributed 90 per cent of the profit applying the gross profit margin of 26 per cent to the PE.

Tribunal's ruling

Subsidiary PE

- The taxpayer has not deputed any of its personnel in India and also the directors of the Indian company have not functioned for the business of the taxpayer. Further, the control over the financial and administrative activities of Indian company by the taxpayer i.e. the Indian company shall account for expenditure and receipts, and shall also report and provide general administrative services to the taxpayer, cannot be result into the control over the Indian entity by the taxpayer resulting into PE. Therefore it cannot be said that taxpayer controls or is controlled by the Indian company or vice a versa.

Fixed place PE

- The AO has not put forth any evidence which leads to the fact that it is not the business of the Indian company, but it is the business of the taxpayer being carried out in India through the Indian entity.
- The Indian company is a separate legal entity, which has its own board of directors, premises, employees, contracts, etc. and the employees of Indian company work under the control and supervision of Indian company only and not the taxpayer for provision of its services to the taxpayer.

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Agency PE

- Common directors of the taxpayer and Indian company are not engaged in the day-to-day activities of the taxpayer's renegotiation of any contracts or performing any marketing functions in India on behalf of the taxpayer. Merely because there are common directors, one cannot say that the Indian company has an authority to conclude contracts on behalf of taxpayer. Even otherwise the common director and holding of the company by itself does not constitute either company as a PE of the other as per Article 5(6) of the tax treaty.
- For holding PE in terms of Article 5(5) of the tax treaty, it is imperative that the agent has and is habitually exercising that authority to conclude contracts on behalf of the taxpayer. The tax department failed to establish with credible evidence that such authority is vested in Indian company and Indian company habitually exercises that authority. The activities of Indian entity are only part of its marketing support services and are for the business of the Indian entity and cannot be said that they are made for sales in India by the taxpayer through Indian entity.
- With respect to the purchase orders the Indian entity do not solicit or accept purchase orders on behalf of the appellant but the purchase orders raised on the appellant are through distributors. The receipt of the purchase orders by the Indian entity is only for facilitation for onward transmission to the taxpayer. In this aspect, the revenue has totally ignored the functions performed for getting purchase orders by the distributors. Even otherwise this function alone do not constitute PE under the provisions of the double taxation avoidance agreement.
- In view of above, the Tribunal observed that the taxpayer does not have agency PE in India.

BEPS

- Further BEPS Action point 7 is also on the issue to address the tax experience that the foreign enterprise is able to avoid the application of Article 5(5) of the OECD Model Tax Convention, to the extent that the contracts concluded by the person acting as a commissionaire are not binding on the foreign enterprise. Since Article 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is possible to avoid the application of that rule by changing the terms

of contracts without material changes in the functions performed in a State.

- Commissionaire arrangements as it is in the present case have been major pre-occupations of tax. In most of the cases that went to court, the tax administration's arguments were rejected. The only answer to that would be factually establishing the role of the Indian companies regarding their actual authority of concluding the contracts.

Service income

- As the services rendered by the taxpayer are installation services, warranty services and professional services. It cannot be said that they are made available to the customers using Net app BV products. In fact, the warranty service is taken by the buyer of the product to keep the goods purchased in good condition for its lifespan.
- In view of this the argument of the tax department that such services fees are chargeable to tax as Fees for Technical Services (FTS) was rejected.

Income from sale of hardware

- As the taxpayer did not have a PE in India, the income of the taxpayer was not chargeable to tax with respect to sale of the hardware products in India.

75. GE Energy Parts Inc. v. ADIT [2017] 56 ITR(T) 51 (Del)

The taxpayer is a US company and is a part of the GE Group. The taxpayer supplies equipment to customers in India relating to oil and gas business, energy business, transportation business and aviation business. The taxpayer is engaged in various sales activities in India, for which the business heads are generally expatriates, who are appointed to head Indian operations, with the support staff provided by GE India and also by various third parties. These expatriates are on the payroll of GE International Inc. (GE) but working for various businesses of GE group. One of the group entity of the taxpayer was having Liaison Office (LO) in India to undertake liaison activities. LO had entered into a Global Service Agreement (GSA) with an Indian company to provide certain support services to the group company. It does not include commercial activities.

A survey was conducted by the tax authorities at the premises of LO whereby certain documents were found. On the basis of information gathered during

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the course of survey, it was revealed that in addition to the liaison activities, the taxpayer has provided commercial and trading activities. The AO observed that marketing and sales activities took place in India. Expatriates from GE were involved and participated in the negotiation of prices. Such negotiations of prices took place in India. The AO also held that the taxpayer had fixed place PE as well as a dependent agent PE in India. Since the taxpayer was making sales in India with the involvement of its PE in India, the profits attributable to such PE were chargeable to tax. The AO deemed 10 per cent value of supplies made to the clients in India as the profits arising from such supplies and 35 per cent of such profit was attributed to the PE in India.

Tribunal's ruling

Fixed place PE

- GE India comprising expatriates from GE were permanently using the LO premises of the group entity. Though the LO premises was taken on lease by the group company, the same was also being constantly occupied by these expatriates, who, though on the payroll of GE, were working in India for the GE Overseas entities. The said premises was also occupied by the employees of other group company of the taxpayer who were working under the direct control and supervision of the expatriates.
- From the job descriptions and appraisal reports with the manager assessment, it indicates that the expatriates were India Country heads or working at the top positions, managing the business, securing orders and doing everything possible that could be done here qua the Indian operations of GE overseas entities in India.
- On reference to the emails found during the course of survey, it indicates that GE India was in full command of the sales activities in India and not allowing GE overseas even to interfere with what they had agreed with the customer in India.
- The activities carried on by GE India from the LO premises were of substantial and core and not merely preparatory or auxiliary. All the three conditions for constituting a fixed place PE under Article 5 of the tax treaty are fully satisfied as LO premises is a fixed place from which business of GE Overseas is partly carried on in India and the activities carried out from such fixed place are not of preparatory or auxiliary character.

Agency PE

- The expatriates of GE and employees of other group company were appointed to act as agent of multiple GE overseas enterprises. Although the number of GE overseas entities looked after by each of them is more than one, the fact that such entities were in one of the three broader lines of businesses of GE group, makes them agents of dependent status per se.
- Para 26 of OECD commentary, though dealing with the activities of preparatory or auxiliary nature, also acknowledges that a fixed place of business which renders services to more than one company would not fall in exemption provided in Article 5 of the tax treaty and hence, constitute PE. Therefore, it has been held that GE India consisting of expatriates of GE and employees of other group companies, etc., are the persons covered in Article 5(4) acting in India on behalf GE Overseas entities.
- Having discussed the nature of activities done by GE India, which are of core nature and not merely preparatory or auxiliary, it has been held that they clearly indicate its authority to conclude contracts on behalf of GE Overseas. Therefore, GE India constituted agency PE of all the GE Overseas entities in India.

Attribution of income

- There can be no hard and fast rule of attribution of profit to marketing activities carried out in India at a particular level. Attribution of profits to PE in India is fact based, depending upon the role played by the PE in the overall generation of income. Such activities carried out by a PE in India resulting in generation of income, may vary from case to case. Attribution of income has to be in line with the extent of activities of PE in India.
- The Tribunal estimated 26 per cent of total profit in India as attributable to the operations carried out by the PE in India. Therefore, as against the AO applying 3.5 per cent to the amount of sales made by the taxpayer in India, it has been directed to apply 2.6 per cent on the total sales for working out the profits attributable to the PE in India.

76. ABB FZ-LLC v. DCIT [2017] 166 ITD 326 (Bang)

The taxpayer is UAE based entity engaged in the business of providing

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regional service activities for the benefit of ABB legal entities in India, Middle East and Africa. In pursuance of the regional headquarter service agreement between the taxpayer and ABB Limited, the taxpayer rendered services to ABB Limited during FY 2009-10 and 2010-11. In terms of the agreement, the taxpayer has received payment from its associate concern. The taxpayer claimed that the above amounts is not taxable in India under the tax treaty, as the tax treaty does not have a clause for FTS. Since this clause has been specifically excluded from the treaty, the taxability would fall under Article 22 of the India-UAE tax treaty. As per Article 22 of the tax treaty the amount would be taxable in India only if the entity has a PE in India and in the instant case since there is no PE in India, the sum is not liable to be taxed in India.

The AO held that the services rendered by the taxpayer would be treated as FTS both under the Act and under the tax treaty as prescribed under Explanation 2 to Section 9(1)(vii) of the Act. In an alternative argument, the AO held that most of the services rendered by the taxpayer were covered under the definition of 'royalty' as per the Explanation 2(ii), 2(iv) and 2(vi) under Section 9(1)(vi) of the Act, as well as under Article 12(3) of the tax treaty. The Dispute Resolution Panel (DRP) confirmed the order of the AO.

The Bengaluru Tribunal held that the taxpayer was having Service PE in India since the taxpayer has been furnishing services to the Indian company even without any physical presence of its employees in India. In the present age of technology the services, information, consultancy, management, etc. can be provided with various virtual modes like email, internet, video conference, remote monitoring, remote access to desktop, etc., through various software. Service PE is not dependent upon the fixed place of business as it is only dependent upon the continuation of the activity.

The Tribunal also held that the services provided by the taxpayer were in the form of sharing or permitting to use the special knowledge, expertise and experience of the taxpayer and it falls under the term 'royalty', under Article 12(3) India-UAE tax treaty. The visits of the officials of the taxpayer was only for the purposes of providing access for using the information pertaining to industrial/commercial/scientific experience and to help to commercially exploiting it. The dominant character of agreement between the taxpayer and Indian company was for sharing secret, confidential and Intellectual Property Rights (IPRs) information made available. The Tribunal observed that tax treaty clearly uses the word for the 'use of' or 'right to use of', commercial, scientific equipment and has not used the word either 'imparting' or

'alienation' of knowhow. The language used in the tax treaty is plain and unambiguous and therefore reading of words 'alienation' or 'imparting' of know-how in the tax treaty would not be permissible.

Royalties & Fees for Technical Services (FTS)

1. Horizontal Drilling International SA. In Re, [1999] 237 ITR 142 (AAR)

The applicant a French company was awarded a contract by Gas Authority of India Ltd. (GAIL) for installation of gas pipelines in India for a consideration of \$ 960,000. The contract was dated 25 October, 1996, but was effective from 15 October 1996 and the work was to be completed by 14 January, 1997. However the work on the contract (rig) actually began on 20 January, 1997 and installation completed on 14 February, 1997. On installation of the rig 10 percent of the contract amount had to be paid to the applicant. According to the completion certificate of 8 May, 1997 the drilling started on 6 February, 1997 and the work under the contract was completed on 4 March 1997.

The applicant had given a Sub-contract to Larsen & Toubro (L & T) an Indian company on 28 October, 1996 in respect of the works executed, but assumed full responsibility for the work. The applicant paid L & T a sum of \$ 210,000 and L & T was responsible for all local support activities, pipelines works and the design, engineering, procurement and installation of the optical fiber cable as per specifications.

The questions before the AAR was whether the applicant was liable to tax under the Act for the Assessment year 1997-98 on the amount received from GAIL on the aforesaid contract dated 25 October, 1996, in the absence of any PE in India, in view of Article 5 and 7 of the DTAA between India and France?

The tax authorities contended that payment was for technical services and was covered under "FTS" and was not to be treated as 'business profits' as the payment in question was for laying of pipelines and was completed by the French company in India within six months. The nature of payment made by GAIL would fall under FTS as defined under Article 13(4) of DTAA between India and France.

The AAR observed that FTS under Article 13(4) of DTAA between India and France means "payments of any kind to any person" other than payments to

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an employee of the person making the payments and to any individual for independent personal services (Article 15). The AAR held that this was a very wide definition when considered in isolation however a limitation of some kind had to be read into it. Paragraph 6 of Article 13 excluded the application of the rule of taxability outlined in paragraphs 1 and 2 of the Article to cases where the recipient and beneficial owner of the fees in question carries on business in the state in which they arise through a PE situated therein. This provision indicates that where the payment to the non-resident arises out of the latter's business and may have been made, in a loose sense of the term, in lieu of services rendered in the course of business including services of technical, managerial or consultancy nature) they should be treated as receipts of business, the chargeability of which would fall under Article 7 of DTAA between India and France and depend on the existence of a PE of the non-resident in the source country. To such receipts Article 7 and not Article 13 would apply. The same would be taxed as business profits if the French company has PE in India.

In the instant case the applicant was carrying out a project for the installation of underground pipelines for the GAIL. If this project had lasted beyond six months, the profits arising to the applicant there from would have been chargeable to tax in India by virtue of Article 7 as part of business profit. In the present case the project has not lasted that long enough to be considered as its PE in India. Hence, its profits cannot be charged as "business profits" in India.

It was therefore held that the applicant was not liable to tax for the Assessment Year 1997-98 on the contract proceeds receivable from GAIL under the contract agreement dated 25 October 1996, in the absence of any PE in India in view of Article 5 and 7 of DTAA between India and France.

2. DECTA v. CIT In re, [1999] 237 ITR 190 (AAR)

The applicant the Developing Countries Trade Agency was incorporated in the UK on 7 April, 1986. Its name was changed to the shorter form "DECTA" on 13 October, 1993. It was a non-resident company for the purposes of the Act and was set up to assist exporters. It had entered into memoranda of understanding with as many as 45 Indian companies from time to time. Under these agreements it received various contributions for its project work to assist exporters and other projects.

The following questions were raised before the AAR:

- (i) Whether the contributions received/receivable to recover part of the cost of the clinical assistance provided by the applicant under the provisions of its aid programme to the companies assisted by it in India is income of the applicant under the provisions of the Act and chargeable to tax?
- (ii) Whether the amount of contribution received/receivable to recover part of the cost of the technical assistance provided by the applicant under the provisions of its aid programme to the companies assisted by it in India is fees for technical services as defined in Explanation 2 to clause (vii) of sub-section (1) of section 9 of the Act or in Article 13 para 4 of the DTAA between India and UK?
- (iii) Even if the amount of contribution referred to in question No.2 be assumed to be in the nature of technical fees, will such fee be chargeable to tax in India keeping the memorandum of articles of association of the applicant in view?

The AAR observed that the Indian rupee contribution goes to meet only the expenses of the staff member and experts of DECTA by way of hotel bills or transport and other local expenses related to the project incurred in India. On this analysis it was clear that this is not a case where DECTA provides technical services to the Indian companies and charges them therefore at a concessional rate. This was a case where the DECTA executed various types of projects which would help Indian companies in their exports and all this is done at the expenses, directly, of DECTA, and indirectly, at the cost of the Overseas and Development Administration (ODA) or the British Government. Only a portion of the expenses incurred locally in India is met by the contributions made by the companies. Therefore, in substance the payments made by the companies cannot be described as consideration for the technical services provided by DECTA. It is, at best, only a pooling arrangement made to meet a part of the expenses incurred on the projects. It would be totally absurd and incorrect to describe these contributions as being in the nature of a payment to DECTA or as fees for technical services within the meaning of section 9 or Article 13.

The AAR accepted the subtle but real difference between the two types of cases in such situation that was brought out in an illustration put forward by the applicant. Suppose a doctor is treating a patient and his normal fee for such treatment is Rs.1,000 but he received from the patient only Rs.500. The

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sum of Rs.500 is the practitioner's fees though it is not commensurate with the market value of the services rendered. Suppose, on the other hand, a doctor, doing social service, offers free medicines or treatment to his patients who are not financially affluent charging no fees or charges for the medicine or other treatment from them. But suppose that, in order to stop them from exploiting his generosity and also in order to inculcate in them a sense of respect for his profession, he tells them that 25 percent of the cost of their medicines and treatment will have to be borne by themselves. This would be a case where the doctor does not receive any consideration for his services and all that is happening is that in the project called medical treatment of his clientele, the patient saves 75 per cent and has to bear only 25 per cent of the expenses involved. Such an arrangement, in the opinion of the Authority does not contain any element bearing the character of income. The contribution by the company also was really not a payment to DECTA but only a contribution to a common fund in the hands of DECTA to enable the latter to defray a part of the expenses of the project carried out by DECTA on behalf of the company in question. Strictly speaking they are in the nature of reimbursement of expenses.

The AAR therefore held that the amount of contribution received/ receivable to recover part of the cost of the technical assistance provided by the applicant under the provisions of its paid programme to the companies assisted by it in India was not income of the applicant under the Act, the amount of contribution received/receivable to recover part of the cost of the technical assistance provided by the applicant under the provisions of its paid programme to the companies assisted by it in India was neither fees for technical services as defined in Explanation 2 to clause(vii) of sub-section (1) of section 9 of the Act nor in Article 13 Para 4 of the DTAA between India and UK.

3. P. NO.22 OF 1996 In re, [1999] 238 ITR 99 (AAR)

In this case there were two groups of companies: On one side:

- (i) A – a Swedish company which was the proprietor of trademark in India;
- (ii) B – the wholly owned subsidiary (WOS) of A incorporated in the USA, which acquired proprietary interest in it;
- (iii) IC- an Indian company in which CM held 51percent.

On the other side:

- (i) C – a company incorporated in the USA;
- (ii) CM – WOS of C

In pursuance of an agreement between B and IC whereby IC was given a right to use the trade mark in India for the business of refrigerators and other articles subject to payment of royalties to B.

This situation underwent a change with a “trade mark usage and purchase agreement” between C, A and B. Under the new agreement the existing rights in the trademark in the hands of A/B were terminated and C purchased all the existing trademarks and trade name licences from ‘B’ and or ‘A’ in favour of “IC”. IC was allowed to use trade mark or trade name during the phased out period of 24 months. B transferred its 51 percent holding in IC to CM. (a wholly owned subsidiary of C)

For the above C paid to B

- (a) One time royalty of US \$ 5,295,756/-
- (b) US \$ 10,524,477 towards 2,086,796 equity shares of IC held by 'B'.

The question rose before the AAR was by 'B' who sought a ruling on payment of royalty;

"Whether the royalty paid outside India amounting to US \$ 5,295,756/- by 'C' to 'B' as a consideration for granting the licence and right to 'IC, a company in which 'CM' has 51 percent equity holding, to use the trade mark in India is liable to Indian tax?"

The applicant contended that the payment of royalty in question would be one deemed to accrue or arise in India under article 12(7)(b) of the DTAA between India and USA, which provides that the royalties paid for the use of, or the right to use, the right or property relate to services performed in India then such royalties shall be deemed to arise in India. However, definition of royalty under Section 9(1)(vi)(c) of the Act is more beneficial to the applicant and since the type of royalty in question do not fall in that definition it would be exempt from tax. [Applicant wanted to invoke provisions of section 90(2) of the Act]. Section 9(l)(vi)(c) of the Act, according to the applicant, would be attracted only if the royalty is payable to a non-resident person, in respect of any right, property or information used for the purposes of a business, profession or vocation carried on by such person in India. Since 'C' made the

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payment and 'IC' is going to use trade marks in India it cannot be said that 'C' made payment to carry on its business activities in India. Therefore, such royalty would be out of the purview of section 9(l)(vi)(c) of the Act.

The AAR observed as regards coverage of section 9(l)(vi)(c) of the Act the applicant's contention missed the second part of that clause which deems royalty to accrue or arise in India where it is payable in respect of the right, property or information used for the purposes of making or earning any income from any source in India. Here there is no reference to the person who is liable to pay the royalty or a business carried on by him in India. Here it is sufficient that the property, in this case the trade mark, in respect of which royalty is payable is used to earn income from any source in India. C was looking to gain a foothold in the Indian market for which it had acquired shares in IC. Thus it cannot be said that C had nothing to gain from the agreement and C had gratuitously paid on behalf of IC.

There is no dispute about coverage of royalty payment under article 12(7)(b) of the DTAA between India and USA. The applicant's representative assumed and even conceded the applicability of the paragraph 7(b) of the Article 12. The AAR therefore held that even in terms of clause (c) royalties in question would be deemed to accrue or arise in India and would be taxable in India. The combined effect of para (a) and (b) of para 7 of Article 12 is that the payer should be a resident of that State, should have a PE in that State and the royalty should relate to use or right to use the property, in this case the third requirement was fulfilled and hence the payment would be royalty even under the DTAA between India and USA.

4. P. NO.30 OF 1999, [1999] In Re, 238 ITR 296 (AAR)

The applicant, "Y" was a US company engaged in the business of credit cards and travel. It had sub-subsidiary, "XT", which was an Indian company. "XT" obtained voluminous data from its clients in India and in other part of Asia about the use of credit cards and travelers cheques by travelers in its region and transmitted it to a Central Processing Unit ("CPU") maintained by Y in USA for processing, got back such processed data and retransmitted the same (i.e. in the processed form) to its clients. The CPU of Y in US is accessed by XT, not directly, but via a Central Data Network ("CDN") of Y installed in Hong Kong. For allowing the use of CDN and CPU, XT pays to Y certain charges (called CPU charges, CDN access charges, CDN service charges & E-mail charges).

The questions raised before the AAR by Y were

- (i) Whether the payment due to Y from XT is liable to tax in India?
- (ii) If yes, whether the payment can be taxed as "royalty" under Article 12(3)(a) (which is taxable @ 20percent) or under Article 12(3)(b) (which is taxable @ 10percent) of the DTAA between India and USA ?

The AAR held that the Indian Company (i.e. XT) accessed the CDN in Hong Kong through which it established access to CPU in USA. At both stage XT was "allowed to use the software developed and protected by the applicant company" (i.e.Y). The AAR further observed that as per commentaries on OCEC Model conventions, any payment for right to use software is to be regarded as a "right to use.... Scientific work". The commentary shows that payments received in such transaction are for the use of intellectual property and partake of the character of royalty. Since the software was customised and secret it was quite clear that the payment had been received on "considerate for use of, or the right to use design or model, plan, secret formula or process" within the meaning of the term "royalties" in Article 12(3)(a). Use by XT of CDN and CPU was not merely use of equipment as envisaged in Article 12(3)(b). CDN/CPU authorised communication and computations with application of sophisticated information technology requiring constant upkeep and updating so as to meet the challenges of the advance of technology in this area It was the use of embedded secret software (an encryption product) developed by Y for the purpose of processing raw data transmitted by XT which clearly fell under Article 12(3)(a). The payment was calculated on the basis of time taken by CPU and it is well known that royalty can be either fixed or variable on certain parameters. Considering all these factors the payment was held to be taxable in India. The AAR held that is liable to tax in India and it is royalty taxable under Article 12(3)(a) of the DTAA between India and USA.

5. ADVANCE RULING P. NO.18 OF 1995, [1999] 238 ITR 575 (AAR)

'A' private limited company and 'B' private limited company are two companies incorporated in Australia. They formed an association known as "A and B" for pursuing and carrying out various kinds of projects in India.

The Australian association along with three Indian associates (namely Development Consultants Ltd., Calcutta, STUP Consultants Ltd., Calcutta, and A-B India Pvt. Ltd.) formed a consortium and entered into an agreement with Port Trust of India, on 30 April 1994.

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The consortium was "to provide consultancy services" necessary for the effective implementation of a project, drawn up by the Port Trust with financial assistance from the Asian Development Bank (ADB).

The consultancy services were in respect of the certain of mechanised coal handling facilities at the Indian Port for handling thermal coal. Four questions were raised before the AAR. Out of the four questions, Question No. 1 was found incorrect at a later date; hence the same was modified with the permission of the AAR. The questions raised were as follows:

- (i) Whether, on the facts and circumstances of the case more particularly set out in the explanatory computation below, this would not be a fit case for a ruling that no tax should be deducted at source on payments amounting to Rs...that are being made to the applicant in terms of the agreement dated entered into between the applicant on the one hand and Indian Port Trust on the other and further that if deduction has already been made by Paradip Port Trust and paid by them to the Income-tax Department should be refunded to the applicant.
- (ii) Whether, on the facts and circumstances of the case (where the applicant joint venture has business operations only in relation to India) the deduction of a head 'Office expenditure' would be subject to limits laid down in Section 44C of the Act?
- (iii) Whether the entire business income of the applicant accruing or arising from this contract would be assessable in India or only that part of it which is reasonably attributable to operations in India?
- (iv) Whether and to what extent services rendered outside India by the applicant to the Indian Port Trust would fall under the definition 'royalties' so as to attract tax in India of such payments under paragraph 2 of Article 12 of the DTAA between India and Australia?

The applicant did not press for ruling on questions (ii) to (iv). The Applicant submitted its arguments in four parts. The arguments in brief were as mentioned below:

- (a) the applicant has a P.E. in India and only that portion of its profits can be brought to tax as is attributable to the P.E. Expenses incurred for the purpose of the P.E. including executive and administrative expenses at the head office in Australia have to be deducted in ascertaining the taxable profits.

- (b) the consultancy services provided outside India cannot be said to be effectively connected with the permanent establishment and payments, therefore, can be taxed only if they can be described as "royalties". However, no part of the payments made to the applicant for services rendered outside India can be termed as "royalties" as the contract involved no element of supply, conveyance or transfer of any technical know-how.
- (c) if the profits attributable to operations carried out in India are to be taken note of, the receipts of the applicant being practically by way of reimbursement of the expenses incurred by it on the employees by way of travel and remuneration, the margin of profits embedded therein was practically negligible.
- (d) in any event, since the activities of the applicant were entirely confined to India, the applicant is entitled, in the computation of its business profits, to deduct the entire expenditure incurred by it including head office expenditure incurred in Australia, without any disallowance under section 44C vide, the decision of the Calcutta High Court in *Rupenjuli Tea Co. Ltd. V.CIT [1990] 186 ITR 301*. It is argued that if this is done, the net profit of the operations of the applicant in this regard would be negligible.

The tax authorities argued that the applicant's case was covered by Article 7 of the DTAA between India and Australia and entire profits would be taxable as business profit and the payments made to the applicant would be income from services rendered in India taxable at the rate of 20.

The AAR expressed difficulties and the practical ineffectiveness of answering question number (iii) to (iv), as they would require detailed scrutiny and assessment. The learned counsel for the applicant agreed to it and did not press them and requested ruling for question No. (i) only. Further, applicant did not seek any ruling for deduction of tax at the rate of 20 percent from payments made to the applicant in Australian dollars.

The applicant submitted three different workings to show how its profits would not exceed 10 percent of the gross receipt under any circumstances. The applicant also cited various section of the Act viz. 44AD, 44AE, 44B, 44BB, 44BBA and 44BBB all dealing with presumptive taxation and wherein maximum rate of tax is 10 per cent.

The AAR observed that there was a substance in the applicant's contention of the 10 percent profits of gross receipts. In fact on the basis of the actual

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figures and projected figures the applicant had actually incurred a loss as far as Indian currency payments are concerned but that overall profits would be about 3.2 percent. Profit element embedded in the payments made in Indian currency was estimated and showed a recovery percentage of about 4.5 percent. Considering all arguments and different workings AAR held that "Tax deduction should be made at the rate of 4.5 percent on all payments made under the contract to the applicant in Indian rupees on or after April, 1995, instead of at the rate of 20 percent.

6. PRO QUIP CORPORATION v. CIT [2002] 255 ITR 354 (AAR)

The applicant was a company resident and incorporated in the USA. An Indian company was engaged in the business of executing the turnkey projects in India, more particularly chemical process plants. The Indian company undertook the work of executing the projects (jointly with foreign contractors) on behalf of its Indian clients and also to help them source for them appropriate technology required for their project and supply the same to them. The Indian company received purchase order from its constituent (a company incorporated in India) for supply of Design, Engineering Technical know-how and erection and commissioning of Hydrogen Generation Plant 2200 NM³/HR capacity for a total consideration of Rs.....Million. As part of the package the said Indian company was required to obtain and supply the Engineering Drawings and Designs for setting up of the said plant. The said engineering Drawings and Designs were available with the U.S. company.

The Indian company placed a purchase order dated 11 December 1998 with the U.S. company (Applicant) for the purpose of specified Engineering, Drawing and Designs for the construction of Hydrogen Generation Plant for its Indian constituent as per the specifications in accordance with the inquiry documents of Indian constituent. The purchase order was for a total consideration of US \$577,500.

In terms of the purchase order the applicant (the U.S. company) supplied various engineering, Drawings and Designs from time to time. The Indian company made the first two payments without deduction of tax at source. However, the Indian company considered the said payments as taxable in India and paid a sum equivalent to US \$ 38,981/- to the Central Government. The said sum of US \$ 38,981 was deducted out of the fourth payment of US \$1,15,500 due to the applicant (U.S. company) (Net payment US \$ 76,519).

However at the time of remittance of the amount after 7 June, 1999, in response to the representation made by the applicant (U.S. Co.) the Indian

company approached the AO to issue NOC for remittance of the said amount without deduction of tax at source, giving detailed reasons. The A.O. issued NOC to the Indian company vide certificate dated 12 August, 1999. Hence, the subsequent amounts were remitted to the applicant without deduction of tax at source. Balance amount of US\$173,250 was not remitted till the date of application and is proposed to be remitted without deduction of tax at source in accordance with the NOC issued by the Income Tax Department.

The applicant (U.S. Co.) submitted that it did not have any income from any source in India, other than income described above and other transactions involving sale of machineries or equipments. As a result the applicant (U.S. Co.) was not required to file any return of income in India, as it did not have any taxable income in India. The following questions were raised before the AAR.

- (i) Whether the applicant is liable to tax on the amount received from Indian company towards consideration for the sale of engineering, drawings and designs received under Purchase Order No 19004 dated 11 December, 1998 of Indian company?
- (ii) Whether the applicant is entitled to the refund of the tax, deducted by Indian company calculated @ 15percent on the part of the total remittance of US \$ 259,875 together with interest on delayed payment of tax deducted at Source and already deposited with bank by the said company aggregating to Rs.17,10,525?

The tax authorities contended that the said payments are covered under clause (b) of paragraph 4 of Article 12 DTAA between India and USA, under the head "FTS". Paragraph 4(a) referred to technical or consultancy services that are ancillary; and subsidiary to the application or enjoyment of an intangible asset for which a royalty is received under a licence or sale described in Article 12(3)(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial or scientific equipment for which a royalty is received under Article 12(3)(b).

The AAR observed that it was a case of out and out sale of engineering drawings and designs by the U.S. Co. (Non-Resident American company) to the Indian company to enable the Indian company to execute an order received by it from another Indian company. The payment basically was not made for any service to be rendered by the American company. This was not a case of a licensing agreement or sale being coupled with a restrictive clause.

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The purchaser was entitled to use the engineering designs and drawings as it liked. It was entitled to sell or transfer the properties purchased. The agreed price of the sale C.I.F. Mumbai airport was fixed and not subject to any escalation or variation until complete execution. All costs, taxes and duties were to be borne by the seller. The agreed price included cost of documentation. The total price of the purchase order was to be the sole consideration for supply of goods as described in the purchase order placed by Indian company and its constituent. U.S. company agreed to carry out the engineering according to the general standard of engineering profession to enable Indian company's constituent to achieve the performance guarantee. In carrying out this engineering U.S. company had to exercise maximum care and diligence. If there were any deficiencies in engineering, U.S. company had to correct and/or complete such engineering at its own cost so that the Indian company's customer could reach the minimum performance guarantee.

The said payment is not Royalty because payments received for the sale of engineering, design or drawings is not contingent upon any of the things mentioned in clause (3) of paragraph (3) of Article 12 DTAA between India and USA.

The AAR analysed further whether the said payment could be "fees for included services" and observed that paragraph 4 includes in the definition of 'fees for included service' payments which are received for *making available technical knowledge, skill, know-how or processes or consists of the development and transfer of a technical plan or technical design*. It can be argued that the American company has made available to Indian company its technical knowledge, experience, skill, know-how, processes, have developed and transfer technical plant or technical design as contemplated in paragraph 4. But paragraph 5 has specifically excluded from the ambit of paragraph 4, amounts paid for services that are ancillary and subsidiary linked to the sale of property other than a sale described in paragraph 3(a). But if, as in this case, there is an out and out sale without any contingent clause then even if such sale included rendering of engineering services, those services cannot be anything other than "services that are ancillary and subsidiary as well as inextricably and essentially linked to the sale of property" in paragraph 5. Therefore, such services will clearly fall within the exclusionary clause of paragraph 5.

In view of this the first question was answered in the negative and in favour of the applicant. As regards the refund of tax deducted by Indian company at

source it was held that the applicant will be entitled to claim refund of the tax deducted at source along with the amount of interest paid for belated payment of advance tax.

7. Airports Authority of India, In re [2005] 273 ITR 437 (AAR)

The applicant, a public sector undertaking, had entered into contracts with a US company, RC in 1993 for modernisation of Air Traffic Services in India (i.e. at Delhi and Mumbai). Under these contracts, RC supplied and installed equipment, together with spares, training, documentation, software etc. After a few years, the applicant entered into two separate contracts with RC in 2003 for the repair of equipment (hardware) and for software maintenance support (i.e. repair of software).

In the case of repair of hardware, the applicant would have to fill in a certain prescribed form and send it along with the failed parts to the RC's facilities outside India. RC would then repair the failed part or provide a compatible replacement from outside India and send it back to the applicant in India.

In the case of software maintenance support, on detecting any fault, the applicant would have to fill a prescribed form and send it to RC with crash data and system sub-data to RC's facilities outside India. If it would be noticed that change in the software was required then the system Trouble Report (STR) would be generated and accordingly changes would be made in various modules (each such change is referred to as STR fix). Various STR fixes would be combined to form a software build which, after due verification, would be sent to India along with a version description document, an executive software DAT Tape and a source Code DAT Tape. RC's software engineers would visit India for a total period of 10 days for verification of the fixes/software build. After testing the same on a simulator and downloading it on to the operational system, it would be monitored for 48 hours. RC did not have a PE in India. All activities in connection with the performance of the contracts would be carried outside India. However, in respect of repair of software, RC's software engineers would visit India for some days for installation and testing of the software.

The applicant sought a ruling from the AAR on whether the deputation of RC's software engineers to India would constitute RC's PE in India, and whether the payments to RC for repair of hardware and software support maintenance would be taxable in India as business profits or fees for included services under the DTAA between India and USA.

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The AAR held that based on the supply contract entered in 1993; there was outright sale of the hardware to the applicant. The AAR gave its ruling noting the following pertinent aspects of the supply contract of 1993:

- (a) The property in the hardware passed to the applicant when the hardware was dispatched for delivery.
- (b) Thereafter RC was in possession/custody of the same for transportation to site, its installation and site acceptance testing, for or on behalf of the applicant, and was not allowed to deal with it for any purposes except for the contract.
- (c) The applicant paid the customs duty for the hardware.

The AAR also held based on the supply contract entered in 1993, that the computer software and technical documentation required to operate the hardware granted a right to use the same to the applicant subject to certain conditions. The AAR gave its ruling noting the following pertinent aspects of the supply contract of 1993:

- (a) A licence was granted to the applicant to use the computer software and technical documentation on the Air Traffic Control System (ATS).
- (b) The licence indicated that computer software and technical documentation were not the property⁵² of the applicant; they were to be used or copied only for the purpose of operating the article or thing in which they were contained.
- (c) There was a stipulation whereby the applicant agreed that the technical data was to be used, reproduced, adopted or otherwise modified only for its ATS in India (i.e. at Delhi and Mumbai).
- (d) The applicant would have to enter into the licence agreement with RC or other relevant proprietors of the computer software and technical documentation for right to use at other locations (apart from Delhi and Mumbai) of the applicant.

The AAR therefore ruled that payment for repair of hardware was business profits of RC, and was thus not taxable in India, as RC did not have a PE in India. The deputation of RC's software engineers to India for installation and testing of the repaired software would not constitute RC's PE in India.

⁵² They were the property of the Queen of Canada.

The AAR observed that the payment for initial acquisition of software was 'royalty'. The payment for repair of software would be fees for included services under Article 12(4)(a) of the DTAA between India and USA as payment was for services which were ancillary and subsidiary to the application or enjoyment of the right, property or information for which a royalty payment was received. The AAR thus ruled that payment for repair of software was taxable as fees for included services.

8. Timken USA India Limited, In re [2005] 273 ITR 67 (AAR)

The applicant, an Indian company, was engaged in the business, *inter alia*, of manufacture and sale of bearings and other ancillary products. The applicant was a subsidiary of a US company (Timken USA). The applicant entered into an agreement on 2 August, 2000 with Timken USA whereby Timken USA rendered various services to the applicant in the USA. The services rendered included management services, system development and computer usage, communication services, engineering services, process in tool design services, manufacturing services etc. The compensation payable by the applicant to Timken USA for services received would cover only the cost actually incurred by Timken USA and no profit element or mark-up on cost would be added to it. The applicant approached the AO for an order under section 195 of the Act authorising it to remit the above payment without deducting any tax, on the ground that the payment was only reimbursement of expenditure/cost actually incurred, not having any mark-up or profit element and so no tax was deductible there from.

The AO passed an order under Section 195 of the Act declining to examine whether the payment had an element of profit embedded in it, as the same would be a subject matter of an enquiry in the course of a regular assessment of Timken USA. The AO held the payment as fees for technical services liable to tax on gross basis⁵³. The applicant preferred an appeal to the CIT (A) but later withdrew the appeals and approached the AAR for its ruling.

The applicant sought a ruling from the AAR on the following questions:

- (a) whether the payment made to Timken USA represented recovery/ reimbursement of the expenditure/cost actually incurred and so the same would not be taxable in India.

⁵³ Sections 9 (1)(vii) and 44D of the Act read with Section 115A of the Act

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- (b) If the payment to Timken USA would be treated as fees for technical, then the same would be taxable on net basis (i.e. granting relief under Sections 28 to 44C of the Act) based on the principles⁵⁴ laid down in decision of the Supreme Court in the case of *Union of India v A. Sanyasi Rao and others* [1996] 219 ITR 330 and so the payment to Timken USA would not be taxable, as it did not contain any element of profit or income in it.

The AAR observed that in *Danfoss Industries Pvt Ltd, In re -* [2004] 268 ITR 1 it had taken a position that an element of profit was not an essential ingredient for a receipt to be taxable as income and even assuming that the fees charged were equivalent to the expenses incurred in providing services and there was no profit element, it would still be a case of *quid pro quo* for the services received by the applicant and not a case of reimbursement of expenses.

The AAR observed that the principle laid down by the Supreme Court in the case of *A. Sanyasi Rao and others (supra)* in interpreting Section 44AC of the Act could not be called in aid in interpreting Section 44D of the Act because the Supreme Court had also observed that Section 44D among other sections related to a non-resident carrying on business in India and its provisions were not much relevant in construing Sections 44AC and 206C of the Act.

The AAR observed that the Supreme Court has not laid down a principle that in every provision dealing with presumptive taxation, where relief under Sections 28 to 43C of the Act was denied, an option could be read to avail of the relief under Sections 28 to 43C of the Act. The AAR observed that in Section 44AC, within the same category of the taxpayers viz domestic taxpayers, different treatment was meted out to different traders in regard to allowability of expenses while computing the income whereas in Section 44D all the foreign companies are treated alike.

The AAR observed that Section 115A of the Act *inter alia* also mandated that no deduction of any expenditure/allowance under Sections 28 to 44C of the Act and Section 57 of the Act should be allowed to the taxpayers in computing their income by way of royalty or FTS.

⁵⁴ Taxpayers liable to pay tax on presumptive basis under Sections 44AC of the Act could not be denied the relief for expenditures/allowances provided under Sections 28 to 43C of the Act.

The AAR held the payment made to Timken USA did not represent recovery/reimbursement of expenditure/cost actually incurred. The same was liable to tax as FTS on gross basis under the Act and the DTAA between India and USA.

9. Tata Consultancy Services v. State of Andhra Pradesh [2005] 271 ITR 401 (SC)

The taxpayer, a company, provided consultancy services including computer consultancy services. The company also provided custom made software to customers on request (referred to as “uncanned software/unbranded software” by the Supreme Court/Andhra Pradesh High Court). The company had also obtained licenses from companies like Oracle, Lotus etc. to sell the software developed and owned by them “off the shelf” (referred to as “canned software/branded software” by the Supreme Court/Andhra Pradesh High Court). The sale of “canned” software was assessed to sales tax under the Act. The Appellate Authorities upheld the assessment.

Lengthy arguments were made before the Supreme Court as to why “software” could not be considered as “goods” and hence would not be liable to sales tax. We briefly consider below some of the noteworthy arguments put forth by the company:

- (a) The main crux of the company’s argument revolved around the submission that “goods” implies a thing, which is a tangible moveable property. Computer software is not a tangible moveable property as software is essentially only a series of commands, which enables the user to run his computer. In order to store the program, it can be converted into a physical form and stored on a CD-ROM or a floppy disc. Therefore, the software, which is intangible, should not be confused with the tangible CD-ROM or floppy disc, which houses it.
- (b) The purchase of software was also unlike the purchase of a book or a painting. On purchase of a book or a painting a purchaser gets a final product whereas on purchase of a software the purchaser does not get a final product or the complete rights to it.

The Sales tax authorities on the other hand contended that the term “goods” under the Act had been given a wide definition and would include all materials and commodities including incorporeal and/or intangible properties.

The Supreme Court relied on various decisions, under the sales tax law, in the context of whether “electricity” could be considered as “goods” and under

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the customs law and held that the term “goods” must be given a wider meaning and need not be something tangible which can be moved or touched. Therefore, any intellectual property when put on to a medium would become a “good” and the fact that some programs may be tailored for specific purposes would not alter their status as “goods”. The Supreme Court supported its view by referring to the decisions of *Associated Cement Companies Ltd. v. Commissioner of Customs* [2001] 4 SCC 593 and *Commissioner of Central Excise, Pondicherry v. M/s. Acer India Ltd.* [2004] JT 2004 (8) SC 53 wherein under the Customs Act and the Excise Act, respectively, the Court had taken a view that the software can be considered as goods or commodity.

The Supreme Court after considering the various submissions laid down a test to determine whether a property is “goods” or not for the purpose of levy of sales tax. The Supreme Court stated that the test is not whether the property is tangible or intangible or incorporeal but whether it can be transmitted, transferred, delivered, stored, possessed etc. and is capable of abstraction, consumption and use and whether it is marketable. Therefore, in simple terms the test is whether the property can be brought to a market place where there is a willing buyer and willing seller.

The Supreme Court observed that applying this test “canned” software would be “goods” and “uncanned” software may fall under the definition of “goods”. An important observation of the Supreme Court is that the sale of the software cannot be split from the sale of the media because what the buyer is willing to pay for is not the media but the intellectual property, as the media by itself has no value. Thus, there is no difference between the sale of a film on a CD and the sale of software on the CD.

The Supreme Court held that “canned” or branded software was “goods” and accordingly it upheld the view of the Andhra Pradesh High Court. In respect of “uncanned” software the Supreme Court held that “uncanned” software may be considered as “goods” but refrained from giving a categorical answer as to whether it definitely would be considered as “goods” on the ground that there may be issues on situs of sale and whether the contract would be a service contract or a contract for sale.

10. DCM Ltd. v. ITO [1989] 29 ITD 123 (Delhi)

DCM Ltd. was *inter alia* engaged in the production of sugar. Tate and Lyle Industries Ltd., London (hereinafter referred to as TL) had extensive

knowledge and experience and was a pioneer in Sugar Technology for many years. It manufactured special dosing and control equipment and possessed valuable and particular know-how in relation to the installation and operation of special equipment, operation of the processes and use of essential speciality chemical products known as "process technology".

The DCM wanted to adopt the "Talo Processes" at its existing sugar factories in India (Debrala). Therefore, DCM on 12 October, 1983 entered into a Technical Collaboration Agreement with TL for the transfer of comprehensive technical information and know-how and supply of equipment by TL to DCM. As per this Agreement, the information relating to "Talo Processes" was to be transferred to DCM by TL outside India. In consideration of the supply of the documents concerning the processes, DCM had to pay a total amount of UK £ 155,000 in four installments. The first installment of UK £ 38,750 was to be made as a down-payment on the effective date of this Agreement and the balance amount of UK £ 116,250 was to be paid in installments of UK £ 77,500, UK £ 23,250 and UK £ 15,500 in accordance with para 6.1 of the aforesaid Agreement.

DCM, therefore, approached the AO for "No Objection" certificates for these remittances. The AO issued one certificate on 27 March, 1984 for UK £ 38,750 and another certificate on 17 May 1984 for UK £ 1,16,250 in both of which it was made a condition that tax at the rate of 20 per cent was to be remitted by DCM in its capacity as a representative assessee. Although the orders of the AO did not specifically say so, such orders were passed by him ostensibly under Section 195(2) read with section 115(1) (ii) of the Act, as applicable at that time, treating the amounts in question as "royalty". The expression "royalty" in Explanation (c) to Section 115A (1) of the Act has been assigned the same meaning as in explanation 2 to Section 9(1)(vi) of the Act. However, the definition of "royalty" as per the DTAA with UK was different which was not taken into consideration by the AO.

The learned CIT (A) accepted the position that the definition of "royalty" under the DTAA would override the definition of "royalty" under section 9(1) (vi) of the Act, however he held that the term "royalty" would include both lump sum as well as periodical payments on account of the use of the expression "payments of any kind" and observed that "technical know-how" was wide enough to cover outright sale of designs or know how as well as provision of technical assistance.

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The taxpayer, DCM, contended that the payments were for equipment and know-how, which were not royalty as defined in the DTAA. Therefore, the assessment thereof had to be considered under “Business Profits”; as TL did not have a PE in India under para 2(j) of Article V of the DTAA as the activity/presence in India was for less than 6 months the income was not taxable in India.

The Tribunal considered the meaning of “royalty” under the DTAA and accepted the contention that payments fell outside the definition of “royalty” under the DTAA and in the absence of a PE were not taxable in India. The Tribunal therefore held that the payment made to the U.K. company as consideration for drawings and designs did not constitute royalty as per the provisions of the DTAA between India and UK, but constituted business profits of the UK company, and not liable to be assessed in India.

11. Lufthansa Cargo India (P.) Ltd. v. DCIT [2004] 140 Taxman 1(Del)

The taxpayer, a company, had acquired four Boeing Cargo Aircraft from a foreign company. The Company obtained a license from the Licensing authority to operate these aircraft only on international routes. The company engaged crew, technical personnel, engineers and other ground staff and ‘wet-leased’⁵⁵ the aircraft to a foreign cargo company.

Under the terms of the wet-lease the responsibility for maintaining crew and aircrafts in airworthy conditions was that of the Company. The lessee paid rental on the basis of number of flying hours subject to a minimum guarantee.

The company engaged the services of certain other foreign companies, *inter alia*, a German, a U.K., and a US company for the overhaul, repairs and maintenance of its aircraft. The company made payments in respect of these services without deducting tax at source. The company did not make an application under Section 195 of the Act to the AO either.

The AO held that the payments were in the nature of FTS, as defined in Explanation 2 to Section 9(1)(vii) of the Act, and therefore chargeable to tax on which tax ought to have been deducted at source under Section 195(1) of the Act.

⁵⁵ Wet-Lease means that an operator leases an aircraft to another carrier providing an airplane with complete crew.

Before the AO the company contended that the income was not chargeable to tax in India in the hands of the recipient foreign companies as the payments for repairs were incurred for earning income from a source outside India and in respect of a business carried on outside India and therefore they fell within the exclusion clause of Section 9(1)(vii)(b) of the Act and in any event the income, if at all, would be assessed as business income in the hands of the non-resident which in the absence of a PE would be exempt under the respective DTAA. The AO however rejected all the contentions of the company and passed orders under Section 201 of the Act holding it to be an 'assessee in default'. The AO also levied interest and penalty under Section 201 (1A) and Section 271C of the Act, respectively.

The company filed an appeal against the orders of the AO with the CIT (A). In respect of the payments made to the German company the CIT (A) held that the service provided required specialized knowledge and were rendered by trained personnel. Therefore, the service would fall within the meaning of FTS and would accordingly be taxable in India. In respect of the payments to the U.K. and US companies the CIT (A) held that the payments made would not fall within the definition of FTS per the respective DTAA's. The payments were held to be business profits in the hands of the companies, however, not liable to tax in the absence of a PE.

The company and the tax authorities preferred an appeal to the Delhi Tribunal. The Delhi Tribunal held that the payments to the non-resident companies could not be said to be FTS under Section 9(1)(vii) of the Act and therefore could not be charged to tax in India. The crux of the issues before the Tribunal could be summarized as under:

- (a) The payments made to the non-resident companies were for routine repairs and maintenance and therefore would not constitute FTS as defined under Section 9(1)(vii) of the Act;
- (b) The payments made were in connection with earning income from a source outside India and therefore would fall under the exclusion in Section 9(1)(vii) of the Act; and
- (c) The payments for repairs of aircraft were made in respect of a business carried on outside India and therefore would fall under the exclusion in Section 9(1)(vii) of the Act.

The Tribunal examined each of the contracts in detail to evaluate whether the services constituted FTS. The Tribunal observed that the company was

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under an obligation to keep the aircraft in airworthy condition. This it could do by either by completely outsourcing the maintenance programme or by managing the repairs etc. on its own and periodically sending the aircraft for an overhaul as per the manufacturers' manual. The company had chosen the latter of the two options and for this purpose had engaged the services of the non-resident companies.

The Tribunal has noted that the following principle could be laid down to establish whether a service could be said to be in the nature of a technical service. If, on facts it could be established that the service was a package deal which included the management of inventories, material co-ordination, transportation and the deputation of qualified personnel the dominant object of the contract would be for provision of managerial and technical service and the repair activity would be incidental to the main object. If, however, the taxpayer company carried out the engineering programme and only repair services were availed of with no interaction between the technicians of the two companies, the contract would be a works contract and not a contract for technical services.

In respect of the contract with the German company the Tribunal observed that the contract was basically in three parts. Parts A and B offered, on request, "engineering support services" and "Assignment of personnel". Part C concerned repairs and overhaul. The Tribunal observed that the company had neither availed of the engineering services nor the personnel services. The bulk of the payment made to the German company was for routine repairs and maintenance. The Tribunal observed that the contract was only a works contract and there was a complete absence of human element as there was no interaction between the technicians of the German company and the taxpayer company.

In light of the facts observed above and the principle laid down the Tribunal held that the contract with the German company was only a works contract and the repair services do not constitute "managerial", "technical" or "consultancy services". In this connection, the Tribunal also relied on the clarification given in question No.29 of the *Circular No 715 dated 8th August, 1995* issued by the Central Board of Direct Taxes (CBDT), which clarified that 'routine maintenance repairs' do not constitute FTS. The Circular is issued under Section 194J of the Act but as the meaning given to FTS in Section 194J of the Act is the same as under Section 9(1)(vii) of the Act the clarification would be relevant while examining section 9(1)(vii) of the Act also.

The Tribunal also observed that the tax authorities could not rely on the decision of *Sahara Airlines Ltd. v DCIT [2002] 83 ITD 11*, as the facts of the case were materially different. In the case of Sahara Airlines the entire programme for supervision and management of the aircraft was outsourced to the French company and it was their responsibility to ensure its smooth running. Thus, in Sahara Airlines' case the services were in the nature of expert technical services as against the case under review where only routine repair services were availed of.

The Tribunal thus held that the service was not in the nature of FTS.

In respect of the contention that as the payments were made for earning income from a source outside India and in respect of a business carried on outside India they would be excluded under Section 9(1)(vii) of the Act, the Tribunal observed that the 'source of income' was the activity of wet-leasing of aircraft to non-resident under contracts made outside India. The payments had been made towards this income earning activity situated outside India and therefore fell within the exclusionary clause of Section 9(1)(vii) of the Act.

The principle that emerges from the Tribunal's observations is that an income could be said to have been earned from a 'source of income' outside India if the source from which the income is derived was situated outside India. In the context of international transaction, source could be said to be 'outside India' if: - (i) the payer was a non-resident, or (ii) the contract with the non-resident was made outside India; or (iii) the activity yielding income took place outside India.

In respect of whether the business could be said to be carried on outside India the Tribunal observed that this question could not simply be answered based on where the head office of the company was situated. The Tribunal also observed that it was settled law that profits of a business could not be said to accrue only in the place where sales take place or revenue was earned but are embedded in each distinct operation. The company carried on most of its business activities outside India; the expenditure in relation thereto was also incurred outside India; thus the business was carried on outside India.

The Tribunal therefore held that the payments were not in the nature of FTS and even assuming for a moment that they were, they would fall within the exclusionary clause of section 9(1)(vii) and would thus not be chargeable to tax in India.

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In light of the above decision the Tribunal did not go into the tax authorities' ground of appeal of whether the CIT (A) was right in holding that the payments to the U.K. company and the US company were business profits not taxable in the absence of a PE.

The Tribunal also dismissed the tax authorities contention that as Section 195 of the Act deals only with payments and not chargeability and therefore the company ought to have made an application to the AO. The Tribunal observed that it was settled law that if the payments were not chargeable to tax no application would be required to be made, as the provisions of section 195 would not be attracted.

The Tribunal accordingly quashed the orders under Section 201/ 201(1A) of the Act and as a consequence thereof also quashed the penalties levied.

The Delhi High Court affirmed this case in **DIT vs. Lufthansa Cargo India (2015) 375 ITR 85 (Delhi)**.

12. Decca Survey Overseas Ltd. U.K. v. ITO (ITA No.8506/BOM/90 and 8628/BOM/91 dated 18 March 2004 (Mum) [unreported]

The taxpayer, a company incorporated in the U.K., was engaged in the business of hydrographic surveying activities. During the year under consideration it had entered into contracts with an Indian company and two foreign companies for carrying out survey and positioning work off-shore India beyond the exclusive economic zone i.e. 12 nautical miles. In connection with the contracts the company had sent its specialized equipment and personnel to the off-shore barges as and when required.

In its tax return, the company claimed that the amounts received from the three companies was not taxable in India in the absence of a PE taking shelter under Article VII of the DTAA between India and U.K.⁵⁶.

The AO held that the service was in the nature of a technical service and therefore the payments would fall under Article XIII FTS of the DTAA between India and UK. The AO further rejected the company's contention that the payments were assessable as "Business Profits" under Article VII on the ground that Article XIII being a special would override Article VII of the DTAA between India and UK.

⁵⁶ Please note that this decision relates to the old India-U.K. DTAA

Without prejudice to his stand that the payments are assessable as FTS the AO has also dealt with and dismissed the Company's contention that it did not have a PE in India. The AO was of the view that the company would have a PE within the meaning of Article V(2)(h), which incorporated within its fold a mine, quarry, or any other place of extraction. The AO held that as the company was engaged in the business of extraction of oil it would fall under Article V (2)(h). The AO was also of the view that as the company was in India on and of since 1980 it would have a PE under Article V (2)(j), which brought within its fold construction and supervisory activities, which last for more than six months. The AO accordingly proceeded to assess the payment made by the Indian company under Section 115A of the Act and the payment made by the non-resident companies under Section 44BB of the Act. The CIT (A) was of the view that the services were in the nature of technical services. The CIT (A) also held that the Company had a PE in India within the meaning of Article V (2)(j) of the DTAA between India and UK. The CIT (A) was however of the opinion that only the profits attributable to the PE were taxable in India and for that limited purpose remanded the matter back to the AO.

The company preferred an appeal to the Mumbai Tribunal. The Mumbai Tribunal held that the payments received are to be assessed under Article XVII as FTS.

The Tribunal dismissed the company's contention that technical services are predominantly based on personal skills of a performer of arts in which the use of equipment is incidental. In the company's case the use of equipment was the substantial part of the contract and therefore it could not be classified as technical service.

The Tribunal on a perusal of the contracts noted that the company made available personnel and equipment and performed survey services. The Tribunal noted that the equipment and personnel are employed together in the rendering of service and both form an important part of the service rendered. The Tribunal thus concluded that the service rendered was in the nature of a technical service. The Tribunal also held that it would not matter if the business of the company was itself to render technical services as even if that be so the more appropriate Article would be the special Article i.e. Article XIII.

The Tribunal therefore held that the payments were in the nature of FTS and would be assessed under Article XIII of the DTAA between India and UK.

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Though in light of the decision above the issue of whether the company had a PE in India would not be very relevant but in order to do justice to the arguments put forward the Tribunal has also dealt with the submissions put forth by the company and the Department. The Tribunal has held that the company could not be held to have a PE under Article V (2)(h) of the DTAA between India and UK by only rendering technical service to persons owning rigs etc. The rig would merely be a place where the service is rendered and not a PE.

As regards Article V (2)(j) the Tribunal noted that the first requirement that the PE should be in India was satisfied as the rig was in the extended definition of India i.e. within the extended boundary of India encompassing 12 nautical miles. As regards the other condition that the activity constituting the PE should last for more than six months, the Tribunal relying on the OECD commentary and the memorandum to the new DTAA signed by India and U.K. noted that the period of six months has to be computed with reference to each project and not from the cumulative presence in India. The Tribunal observed that as both the cumulative conditions were not satisfied there would not be a PE under this clause either.

The Tribunal thus held that the income was taxable in India under Article XIII of the DTAA between India and UK.

13. TVS Suzuki Limited v. ITO [2000] 73 ITD 91 (Mad.)

Pursuant to a technical collaboration agreement, the taxpayer made certain remittances to AVL Austria in the years relevant to assessment years 1991-92, 1992-93 and 1993-94 for undertaking technical study on, and making improvement in fuel efficiency of the engines of the taxpayers two-wheelers and modifications of engine parts by design changes and by experimental measures.

The taxpayer would have world rights on the drawings, calculation and reports made by AVL and AVL would not disclose the information to any third party. The services were entirely rendered outside India. The RBI had approved the agreement as Technical Aid Agreement. The taxpayers contention was that the payments constituted technical know-how fees for services rendered outside India. As per the DTAA between India and Austria such fees are taxable in India only to the extent the services are rendered in India. Hence, the fees were not liable to tax. The AO had issued a No-Objection certificate for remitting the monies without deduction of tax under

section 195. The AO's view was that the subject payments constituted royalty as per the provisions of the Act as well as of the DTAA between India and Austria and consequently, liable to withholding tax. As the taxpayer had made the payments without deducting tax, the ITO held the taxpayer as an 'assessee in default' under Section 201(1) of the Act and also levied interest under Section 201(1A) of the Act. The CIT(A) dismissed the taxpayers contention that there was no liability to withhold tax.

Whether the provisions of DTAA prevail over those of the Act? If yes, whether the payments constituted 'royalty' or 'technical know-how fees' as per the DTAA between India and Austria?

Based on section 90 of the Act and judicial precedents, the provisions of the DTAA would prevail over those of the Act. In view of the provisions of section 90(2) of the Act, the definitions in the DTAA between India and Austria would prevail over those given in the Act. The impugned payments were not royalty in accordance with the provisions of the DTAA as:

The entire know-how was absolutely to be passed to the taxpayer; AVL was not a manufacturer of two wheelers and was only a consultant; there was no grant of any right to use property of AVL; the DCIT had issued a No-Objection certificate remitting without withholding tax on the payments; and the taxpayer had filed a certificate from the auditor of AVL that the payments were accounted for as technical services fee income and subjected to tax in Austria.

Since the technical services were rendered by AVL in Austria the fees were liable to tax in Austria and would not be liable to withholding tax in India.

This appeal is upheld by the Madras High Court in case **DIT vs. TVS Motors Co. Ltd. (2018) 259 Taxmann 140 (Madras)**.

14. CIT v. Ruti Machinery Works Ltd. [2000] 243 ITR 442 (Mad.)

The taxpayer, was a company incorporated in Switzerland manufacturing weaving machines. It entered into collaboration with an Indian company under which the Indian company was to manufacture the machines in India, and the taxpayer was to subscribe to 25percent of the equity capital and have 2 nominee directors in the Indian company. The taxpayer handed over all the relevant documents required for manufacturing the machines to the Indian company in Switzerland, for a consideration of one million Swiss Francs, free of Indian taxes, which had to be paid in cash in Switzerland in 3

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equal instalments. The agreement also provided for a payment of royalty to the taxpayer on the weaving machines manufactured in India by the Indian company. For assessment years 1976-77 to 1980-81, the AO held that the amount received as consideration by the taxpayer for the documents supplied by it and the royalty received by it were exigible to tax.

On a reference, the Court held that as the documents had been handed over to the Indian company in Switzerland, and the payment therefore in cash was also made in Switzerland, the amount of one million Swiss Francs received by the taxpayer as consideration for the documentation supplied to the Indian company was not exigible to tax in India. However, the royalty payment made to the taxpayer was clearly a payment in respect of the products manufactured in a business carried on under licence from the taxpayer, and the taxpayer itself had an interest in the business, as a shareholder and having appointed 2 nominee directors on the board of the Indian company. Therefore, there was a business connection between the taxpayer and the Indian company, and the said royalty had accrued or arisen to the taxpayer in India and was taxable in its hands.

15. CIT v. Neyveli Lignite Corporation Ltd. [2000] 243 ITR 459 (Mad.)

The taxpayer was engaged in the mining of lignite. It entered into an agreement with a Hungarian company, for acquiring steam-generating plants with auxiliaries for more efficient running of the business. The AO held that the amounts paid under the contract were income that had accrued to the Hungarian company in India, and, hence, the taxpayer was required to deduct tax at source on such payments.

The Tribunal held that the payment could not be regarded as royalty. The term "royalty" normally connotes the payment made by a person who has exclusive rights over a thing for allowing another to make use of that thing which may either be physical or intellectual property or thing. The exclusivity of the right in relation to the thing for which royalty is paid should be with the grantor of that right. Mere passing of information concerning the design of a machine which is tailor-made to meet the requirement of a buyer does not by itself amount to transfer of any right of exclusive user, so as to render the payment made therefore being regarded as "royalty". On a reference, the Court observed that the price paid by the taxpayer to the supplier was a total contract price covering all the stages involved in the supply of machinery from designing to commissioning. The design supplied was not to enable the

taxpayer to commence manufacture of the machinery itself with the aid of such design. The design referred to in the contract was only the design of the equipment required to be manufactured by the supplier abroad and supplied to the purchaser. There was no transfer or licence of any patent invention, model or design owned by the supplier that the buyer was permitted to exploit. The information concerning the working of the machine was incidental to the supply as the machinery was tailor-made for the buyer. Unless the buyer knew the way in which the machinery had been put together, the machinery could not be maintained in the best possible way and repaired when the occasion arose.

The Court concluded that Section 9(1)(vi) and (vii) of the Act would have no application as the design was only preliminary to the manufacture and not integrally connected therewith. Therefore, the payments made were not liable to deduction of tax at source.

16. Director of Income-tax v. Paper Products Ltd. [2002] 257 ITR 1 (Del.)

The taxpayer, a company, imported printing machines from Rotomac SPA, Italy (Rotomac). The company was required to remit US \$ 50,000 to Rotomac for erection, assembly and commissioning of these machines. The Company applied under Section 195(2) of the Act to remit this sum without deduction of tax at source.

The AO directed the company to deduct tax at source at 30 per cent on the ground that the DTAA between India and Italy does not have article on FTS and the matter was covered under residuary Article 23 of the DTAA.

The CIT (A) set aside the order of the AO and held that the remittance was covered by Article 15 of the DTAA as the stay of the technicians of Rotomac in India was for less than ninety days. Hence, the Company was not required to deduct tax at source from the payment to be made to Rotomac.

The Tribunal confirmed the order of the CIT (A) and held that Rotomac did not have a permanent establishment in India as the stay of their technicians in India was not more than ninety days in each of the two years. These payments were not liable to tax in India under Article 15 read with Article 5(2)(h) of the DTAA. On a reference, the High Court confirmed the order of the Tribunal.

17. Elkem Technology v DCIT [2001] 250 ITR 164 (A.P.)

The taxpayer, a non-resident company based in Norway, entered into a contract with an Indian company – Sponge Iron India Limited ('SIIIL') for supply of equipment, engineering data and personnel services. 'SIIIL' remitted the fees after deducting tax at source and filed a return as agent of the foreign company claiming that the consideration is not chargeable to tax in India.

The taxpayer contended that the composite amount was the consideration received for construction and assembly undertaken and hence excludible from the definition of fees for technical services in view of the specific exclusion contained in Explanation 2 of Section 9(1)(vii) of the Act. Further, such payment was in the nature of a 'Business Profits' and hence it was not taxable in India since the taxpayer did not have a permanent establishment in India in terms of the DTAA entered into between India and Norway.

The AO, however, did not accept this contention and taxed the consideration on a gross basis at 15 per cent. This action was upheld both by The CIT(A) and the Tribunal.

The High Court held that under Section 9(1)(vii)(b) of the Act, the expression used is '*fees for services utilised in India*' and not '*fees for services rendered in India*'. The High Court observed that, it might be that some of the services are rendered abroad by the personnel employed by the taxpayer under the agreement with SIIIL. But if the fees are paid for services utilised by SIIIL in its business carried on in India, irrespective of the place where the services are rendered the amounts should be deemed to accrue or arise in India.

The High Court accordingly held that there is no merit in the contention that as per the terms of the agreement payments made by SIIIL were for the purchase of equipment and towards consideration for construction of the project and therefore Section 9(1)(vii) of the Act is not applicable. The High Court also placed reliance on the decisions of *Cochin Refineries Ltd. v. CIT (1996) 222 ITR 354 (Ker)* and *Steffen, Robertson and Kersten Consulting Engineers v. CIT (1998) 230 ITR 206 (AAR)* and upheld the decision of the Tribunal.

The High Court dismissed the appeal of the taxpayer since the appeal did not involve any substantial question of law.

18. DDIT v. Preroy AG [2010] 39 SOT 187 (Mum)

The taxpayer, a company incorporated in Switzerland, was engaged in the business of providing strategic consulting services like advising clients in matter related to strategic issues such as establishing joint ventures, technology transfers and related matters, etc. The taxpayer also provides support to and monitors joint ventures and other collaborations on an ongoing basis, to ensure that cooperation between the business partners involved continues smoothly.

The taxpayer entered into a strategic consulting services agreement with an Indian company to render services under the agreement at any place outside India, depending on their requirements. Further, the taxpayer was to make an endeavor to locate new business opportunities and partners for the Indian Company and recommend proposals for new projects for technology transfers, equity participation, etc.

The fees for the services rendered by taxpayer were to be determined in accordance with the compensation clause of the agreement and it will not be affected either by the success or failure of a project, strategy or business approach recommended by taxpayer.

The taxpayer claimed that the fees received from the Indian Company were not taxable in India as per the provisions of the DTAA. However, the AO held that the fees received by the taxpayer were taxable as Royalty or alternatively as FTS in India.

On appeal, CIT(A) held that the fees received by the taxpayer were not in nature of royalty or FTS within the provisions of the DTAA. The CIT (A) also held that the since the taxpayer did not have PE in India the business income of the taxpayer cannot be taxed in India.

On further appeal by the department before the Tribunal, it held as follows:

Taxability as FTS

- The wordings of the Article 12(4)(b) of the DTAA between India and Switzerland dealing with FTS are identical with the Article 12(4)(b) of the DTAA between India and USA. Therefore, the MOU to the India-USA treaty can be looked into to see what meaning India and Switzerland would have contemplated in the DTAA.
- It is a settled law that a DTAA with one country can be compared with the DTAA with another country in case of ambiguity and in order to

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understand the true scope and meaning of the concerned DTAA. The above propositions have been held by the Karnataka High Court in the case of *AEG Telefunken*.

- The Tribunal after relying on the decision of the Mumbai Tribunal in the case of *Raymond Ltd.* held that as per the DTAA, the services must be made available to the taxpayer in order to qualify as FTS.
- The provision of service in the present case may require technical input by the person providing the service, does not per se mean that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of Article 12 4(b) of the DTAA. Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available.
- Further, it was clear from the nature of service that the technical knowledge, experience, skill continues to remain with the taxpayer even after conclusion of the agreement and nothing was made available to Indian Company by the taxpayer. Services are not made available for its future use or utilization on reasonably permanent basis. Therefore, the receipts in question cannot be said to be in the nature of FTS.

Taxability as Royalty

- The Tribunal based on the OECD Commentary on Article dealing with royalty observed that in a contract involving the provision of know-how, the emphasis is on enabling the recipient to use the know-how on its own account. As against this, in a contract for rendering advisory services, the consultant uses his skills to merely execute certain work for the service recipient. There is no effort involved in educating the user to reproduce the processes involved in rendering the services.
- In other words, a consultant may give a certain advice based on his experience. However, there is no imparting of experience in rendering advisory services.
- Consideration for information concerning industrial, commercial and scientific experience is to be regarded as Royalty, only if it is received for imparting know-how. However, providing strategic consulting services, which may entail the use of technical skills and commercial experience by a strategic consultant, does not amount to know-how being imparted to the buyer of the strategic consulting services.

- Accordingly, the Tribunal held that since the taxpayer was only rendering consultancy services and was not imparting any know-how to the Indian Company, the amount received by the taxpayer cannot be considered to be in the nature of Royalty.

19. Real Resourcing Limited [2010] 322 ITR 558 (AAR)

The applicant, a company incorporated in UK, is a tax-resident of UK. The applicant proposed to render following services in India:

- Recruitment services where the applicant would place a candidate with an Indian company and receives payment for providing such service from the Indian company.
- Referral services where the applicant would refer potential Indian clients to a third party based in India for which the payment will be received by applicant from the third party in India.

Issue before the AAR

Whether the payments received by the applicant for the proposed recruitment services and referral services are liable to be taxed in India?

The applicant contended that the payments received by it in respect of the services provided were not chargeable to tax as it has no PE in India.

The office of the applicant in India is basically a virtual office i.e. the applicant has rent the use of address and telephone address in New Delhi for the purpose of communication but does not have actual office space in India and therefore, the applicant does not have any kind of physical presence in India. As per the DTAA the provision relating to 'fees for technical services' is not attracted. Therefore, while making the payments to the applicant, the Indian clients are not obliged to withhold tax under Section 195 of the Act.

The Applicant also relied on the decision of the AAR in the case of Cushman & Wakefiled (S) Pte Ltd⁵⁷

AAR's ruling

AAR observed that collecting data and analyzing it and making a data base for providing information on suitable candidates for recruitment, even if they are in the nature of consultancy services, cannot be considered to be

⁵⁷ Cushman & Wakefiled (S) Pte Ltd., In re[2008] (305 ITR 208)(AAR)

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ancillary and subsidiary to the application of the right or information. Therefore, article 13(3) of the DTAA was not attracted. Moreover, by giving access to the data base, it cannot be said that the information concerning industrial, commercial or scientific experience will be transmitted by the applicant to the recruiting agencies. It would amount to unwarranted expansion of the terms FTS and Royalties.

Consideration for providing information concerning industrial, commercial or scientific experience basically involves the sharing of technical know-how and experience which is not the case here.

It would be far-fetched to suggest that the ingredient of 'making available' technical knowledge, experience, skill, know-how or process is involved in this case. Taking steps to make available the experience and skill of candidates available for recruitment does not at all fall within the ambit of making available the technical knowledge and experience of the service provider. The AAR relied on the decision of its own in the cases of Anapharm Inc⁵⁸, Intertek Testing Services India (P) Ltd⁵⁹ and Cushman & Wakefield (S) Pte Ltd.

AAR also observed that catering the function of referring the potential Indian candidate to the Indian based recruitment company without creating any commitment to recruit them does not give rise to an inference of PE in India. For rendering such services, a fixed place of business in India or dependent agent need not necessarily be there. The AAR agreed with the applicant's contention that the Delhi office of the applicant is basically a virtual office and it was held just for the purpose of communication.

Accordingly, the AAR held that the receipts in the nature of referral fee from the Indian based recruitment company cannot be subjected to tax as 'business profits' in the absence of a PE in India. It is important to note that AAR also held that this ruling would only apply to referral services and not for the recruitment services as details were not made available either by the applicant or the tax department.

20. Bharti AXA General Insurance Corporation Ltd [2010] 326 ITR 477 (AAR)

The taxpayer, a company incorporated in India, is engaged in the business of general insurance. The tax payer entered into a Service Agreement with its

⁵⁸ Anapharm Inc. [2008](305 ITR 394) (AAR)

⁵⁹ Intertek Testing Services India (P) Ltd. [2008] (175 Taxman 375) (AAR)

foreign affiliate for receiving assistance such as business support, marketing, information technology support services and strategy support etc.

For rendering the above services, a fee based on actual cost incurred plus a mark up of five percent is charged on the taxpayer.

The taxpayer stated that the above services are merely advisory in nature and are procured with the intention of carrying on business in line with the best practices followed by other AXA group entities globally.

The applicant contended that for providing the above services no employee of its affiliate will physically visit India. Further, it has no business establishment in India.

Issues before the AAR

Whether the payments made by the taxpayer to the foreign affiliate for various services under the Service Agreement are in the nature of FTS or royalty within the meaning of Article 12 of the DTAA?

Based on the answer to the above question, would the receipt from the taxpayer suffer withholding tax under Section 195 of the Act?

AAR Ruling

On payment for services as FTS

The AAR held that only the services which make available technical knowledge, know-how, etc, which facilitates the person acquiring the services to apply the technology, can be considered as FTS within the meaning of Article 12 of the DTAA.

In the present case the taxpayer, receiving the following services, is unable to apply neither the technology, knowledge, skills etc. possessed by its affiliate nor its technical plan

- Suggestions to improve the product developed by the taxpayer so as to bring it in line with the common practices followed by other AXA entities across the globe
- Providing HR support assistance
- Assistance in choosing cost effective re-insurance partners
- Reviewing the actuarial methodologies developed by the applicant and providing suggestions.
- Marketing and risk analysis.

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In view of the above the AAR held that the payments made by the tax payer to its foreign affiliate for various services under the terms of the Service Agreement are not in the nature of FTS.

On payment for services as Royalty

With respect to IT support services, taxpayer's foreign affiliate provided access to software applications and to the server hardware system hosted in Singapore.

In this regard, the AAR observed that the payments made for accessing the system hosted in Singapore is for availing facilities and it cannot be said that applicant has been conferred any right of usage of the equipment located abroad, more so when the server is not dedicated to the applicant.

The AAR further held that there is no transfer of any copyright contained in the computer software and therefore the IT support services are not in the nature of royalty.

The AAR concluded that since the services provided under the Agreement were neither FTS nor Royalty and the foreign affiliate did not have any permanent establishment in India, the applicant is not required to withhold tax under Section 195 of the Act.

21. Kansai Nerolac Paints Ltd v. ADIT [2010] 134 TTJ 342 (Mum)

Taxpayer has offices in several locations which are interconnected by an online real time accounting systems. Taxpayer acquired software from a foreign company to enable transfer of data from main server to an auxiliary server. It obtained a non-exclusive non-transferable licence to make copies of the programme to enable operation of the programme within its own business. No source code or programming language or technique would be provided with the programme.

The taxpayer relied on the OECD commentary on Article 12 which states that when rights in relation to act of copying is transferred to enable the effective operation of program by user, the payment will be considered as commercial income in accordance with Article 7. It was argued that the payment in the hands of foreign company was not taxable in India under the DTAA since it did not have a PE in India under the DTAA. Accordingly, the taxpayer requested the AO to issue a certificate of deduction of tax at source in terms of Section 195(2) of the Act.

The AO however, held that the foreign company remained the absolute owner of the computer software and the taxpayer had been allowed to use the licensed software for a fee. Accordingly, the payment made by the taxpayer to the foreign company would be in the nature of royalty as per the DTAA.

On appeal, CIT(A) held that the payment made by the taxpayer is for the use of the secret process owned by the foreign company and, therefore amounts to royalty. Further in case of normal sale anybody can pay and buy anything whereas in the case of copyright sale an agreement is necessary. Since an agreement was executed it is a copyright sale. Also, the taxpayer is only having a right to use the software and no ownership is vested. Hence the transaction is not a case of sale but only a royalty agreement.

Tax payer contended that the software gives the taxpayer a license to use like any other software. The taxpayer does not get any right in copyright but gets a right only to use. Reliance was placed on the decision of the Supreme Court in *Tata Consultancy Services and Motorola Inx & Dassault Systems* to contend that the transaction is a sale of a copyright

The Tribunal after hearing the contentions relied on the Supreme Court decision which held that the copyright in the programme may remain with the originator of the programme but the moment copies are made and marketed, it becomes goods susceptible to sales tax. Intellectual property, once it is put on to a media, whether in the form of books or canvas or computer discs or cassettes, and marketed would become “goods”. Accordingly, a transaction of sale of computer software package off the shelf is clearly sale of “goods” as per sales tax law in Andhra Pradesh.

Further, reliance was placed on the Bangalore Tribunal’s decision in the case of *Samsung Electronics Co. Ltd.* wherein it was held that where no right is granted and mere purchasing the copy of copyrighted article does not constitute income in India . Hence no tax is to be deducted in India under Section 195 of the Act.

The Tribunal relying on the principles laid down by the various judicial decisions held that computer software when put into a media and sold becomes goods like any other audio cassette or painting on canvass or book.

Accordingly, the amount paid by the taxpayer to the foreign company for purchase of software cannot be treated as payment of royalty taxable in India under Article 12 of the DTAA and the taxpayer is not liable to deduct tax at source under Section 195 of the Act.

22. ITO v. Cadila Health Care Ltd [2017] 78 taxmann.com 330 (Ahd)

During the year under consideration the taxpayer had made certain remittances towards technical consultancy and professional services without deducting tax at source. The AO had passed order under Section 201(1) and 201(1A) read with Section 195 of the Act stating that payments made by the taxpayer to the U.S.A., Canada and Belgium entities were in the nature of FTS within the meaning of Section 9(1)(vii) of the Act. The AO observed that the payment made to the foreign parties were taxable in India under India-U.S.A. and India-Canada tax treaty as the services were made available in the form of report on analytical study as per the agreements. Further the services provided by the Belgian parties were FTS as per Article 12(3)(b) of the India-Belgium tax treaty. The CIT(A) held that that the services provided to the taxpayer by the non-resident parties did not fall within the purview of included services/technical services and hence there was no liability on the taxpayer to deduct tax at source under Section 195 of the Act.

Regarding the payment made to the U.S.A. and Canada entities, the Tribunal observed that the coordinated bench in taxpayer's case for earlier years decided the similar issue in favor of the taxpayer stating that the services provided by nonresident did not involve any transfer of technology. Article 12(4)(b) of the tax treaty with the U.S.A. and Canada is not applicable since the non-resident parties did not 'make available' any technical knowledge, and the services rendered to the taxpayer by the above foreign parties has not transmitted any technical knowledge. Mere provision of services cannot be said to result in a transfer of technology as the taxpayer has not derived enduring benefits to utilise this knowledge on his own. Regarding payments to Belgian entities, the Tribunal observed that services rendered by the non-resident were for the purpose of due diligence in connection with the proposed acquisition outside India. The services were rendered outside India and utilised outside India. The scope of FTS Article under the India-Canada tax treaty and the India-U.S.A. tax treaty is more restricted than that under India-Belgium tax treaty. Because of the Most Favoured Nation (MFN) clause, the language of FTS Article of the aforesaid two treaties shall apply to the India-Belgium tax treaty. In view of above, the services provided to the taxpayer by the non-resident parties did not fall within the purview of included services/technical services and hence there was no liability on the taxpayer to deduct tax at source under Section 195 of the Act.

23. Robert Bosch GmbH v. ACIT [2010-TII-149-ITAT-BANG-INTL]

The taxpayer, a German Company, entered into a technical collaboration agreement (the Agreement) with an Indian Company for the supply of know how, right to use the technology, patent, design etc. By virtue of the right to use know how, the Indian Company will manufacture certain products which will be sold to the taxpayer and to other parties. As per the Agreement entered into between both the parties, the Indian Company will pay 5 percent royalty on all the products manufactured by it, i.e. products manufactured for the taxpayer and for others. However, 5 percent royalty paid to the taxpayer on the products manufactured for the taxpayer will be recovered by the Company from the sales invoice charged to the taxpayer. Later, the terms of the Agreement was altered to charge 5 percent royalty only on sales made to customers outside the manufacturing territory. However, no royalties have to be paid for the export of contract products to the taxpayer provided the prices invoiced by the Indian Company for these contract products do not include any value for royalties.

For the year under consideration, AO observed that if those products were sold to any other party, they would have included the value for royalty and the same would have suffered TDS. Accordingly, the AO held that since the invoices raised by the Indian Company on the taxpayer were already reduced by the value of royalty, the same was deemed to have been paid to the taxpayer without deduction of tax and consequently, there was understatement of income by the taxpayer to that extent.

The taxpayer contended that as per Article 12 of the DTAA, only such royalty that was actually received by the taxpayer in India could be brought to tax and since taxpayer had not received any part of the payment in India, it was not liable to be taxed in the taxpayer's hands in India. The amount calculated by the AO was a 'notional income' and since it does not fall within the ambit of Section 5(2) read with Section 9(1)(vi) of the Act and the DTAA, the amount received by the taxpayer was not taxable in India. Further, since the taxpayer was the owner of the know how the question of Indian Company paying royalty to the taxpayer did not arise.

The tax department contended that the amount calculated by the AO constitutes 'real' income and not the notional income of the taxpayer.

In appeal before the tribunal, the Tribunal observed that the AO's conclusion was based only on presumption that royalty was deemed to have been paid

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to the taxpayer by the Indian Company without deduction of tax. However, the AO had not brought any tangible proof on record to suggest that he has been armed with powers to lift the corporate veil and see the real and true nature of the transaction. Further, the tribunal held that the taxpayer has every right to arrange itself legally in a position in order to reduce its incidence of tax.

When the know how belongs to the taxpayer, it is its prerogative to charge the Company for the use of its' know how. Charging royalty for the products supplied to the taxpayer and the same to be added back to the invoice by the Company will have nil effect. The taxpayer is not expected to make royalty income with reference to the sale effected to it by the Company, when know how for manufacture of the same is supplied by the taxpayer itself.

24. New Skies Satelites NV v. ADIT [2009] 319 ITR (AT) 269 (Del)

Conflicting decisions of the Delhi Tribunal concerning similar payments in the case of AsiaSat⁶⁰ and PanAmSat⁶¹ led to the constitution of the Special Bench of the Delhi Tribunal. It was held that payments made by telecasting companies to satellite companies for telecommunication or broadcasting constitutes royalty under provisions of the Act as well as various tax treaties.

Issues before the Special Bench

- Whether the services rendered by the taxpayers through their satellites for telecommunication or broadcasting amount to 'process'?
- Whether the term 'secret' appearing in the phrase 'secret formula or process' in Explanation 2 to Section 9(1)(vi) of the Act and in the relevant article of the tax treaties qualify the word 'process' also?
- If the term 'secret' qualifies the word 'process' also, whether the services rendered through secret process only will be covered within the meaning of royalty?
- Whether the payment received by the taxpayers amounts to 'royalty' and if so, whether the same is liable to tax under Section 9(1)(vi) of the Act read with relevant provisions of DTAA as applicable?

⁶⁰ Asia Satellite Telecommunications Co. Ltd. v. DCIT [2003] 85 ITD 478 (Delhi ITAT)

⁶¹ DCIT v. Pan AmSat International Systems Inc. [2006] 9 SOT 100 (Delhi ITAT)

Special Bench's Ruling

Responses to specific queries:

- Services rendered by the taxpayers through their satellites for telecommunication or broadcasting amounts to “process.”
- The terms ‘secret’ appearing in the phrase ‘secret formula or process’ in Explanation 2 to Section 9(1)(vi) of the Act and in the relevant Article of the DTAA will not qualify the word ‘process’. Therefore, it is not necessary that the services rendered must be through ‘secret process’ only. Services rendered even through ‘simple process’ will constitute royalty.

Additional findings:

‘Use’ or ‘right to use’ the process vests with the telecasting companies

- The process embedded in the transponder is ‘used’ by the telecasting companies and not by the satellite companies as they do not have any control either on the data to be uplinked/ downlinked or at the time of uplinking/ downlinking. The role of the satellite companies is restricted to maintain the health of the transponders and satellite to ensure uninterrupted use of transponders by the telecasting companies;
- In a similar case of PanAmsat in China, the Chinese Court has acknowledged that there is right to use with the telecasting company for the bandwidth provided by the satellite company and it was used by the telecasting company for signal transmission; and
- The argument is further strengthened in view of the Satcom Policy, which clearly states that the Satcom Policy shall be provided for users to avail transponder capacity from both domestic/ foreign satellites.

Absence of punctuation mark ‘comma’ after the words secret formula or process in the Act and existence of such ‘comma’ in the provisions of the DTAA is irrelevant for interpretation of the DTAA

- Based on judicial precedents, the Tribunal has held that punctuation is not a controlling element and cannot be allowed to control the plain meaning of a text. The only exception is a case where the statute in question is carefully punctuated. In that case, punctuation may be resorted to for purpose of construction.

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- Principles of literal interpretation do not apply to interpretation of tax treaties. To find the meaning of words employed in the tax treaties we have to primarily look at the ordinary meanings given to those words in that context and in the light of its objects and purpose.
- Accordingly, the word 'secret' does not qualify the word 'process' under the definition of royalty under the relevant tax treaties.
- 'Secret process' does not mean that the process is unknown or mysterious since it is not possible in the commercial world to keep processes *stricto sensu* secret. Secret process should mean that access to the process is checked/ restricted or made secure.
- Accordingly, even if the argument that only 'secret' process qualifies as royalty is accepted, it will not exonerate the taxpayer from its liability to pay tax as 'secret process' since it is matter of record that telecasting process is a secure process.

Application of principles of interpretation known as “*ejusdem generis*” and “*noscitur a sociis*”

- These rules of construction prevail only in cases where intention of the legislature is not clear. Accordingly, these rules have no application when the meaning is not in doubt.
- On the basis of the above, the argument of the taxpayers that 'process' must be intricately linked to IPRs was refuted.

Applicability of Clause (vi) of Explanation 2 to Section 9(1)(vi) of the Act

As per Clause (vi), the definition of royalty includes payments for 'rendering of any services' in connection with the use of any patent, invention, model, design, secret formula or process or trade mark or similar property.

Therefore, even if it is accepted that the taxpayers were merely providing 'services', the same would also fall within the ambit of royalty under the Act by virtue of the aforesaid Clause.

Applicability of Ishikawajima-Harima Heavy Industries Ltd. to Section 9(1)(vi)

It has been clarified by the Explanation to Section 9 inserted by Finance Act, 2007 that where the income is deemed to accrue or arise in India *inter alia* under Clause (vi) of sub-section (1), then, such income shall be included in

the total income of nonresident irrespective of the fact that the non-resident has a residence or place of business or business connection in India. Thus, existence of satellite in the territory of India is not a condition precedent for taxability of royalty received by the taxpayer.

25. DDIT v. Euro Rscg(s) Pte Ltd [2009-TIOL-708-ITAT-MUM]

The taxpayer, a Singapore company was one of the leading integrated marketing communication agencies and it was not having PE in India. Taxpayer was acting as a communication interface between multinational clients and various group entities. On the basis of above facts the AO held that the taxpayer company was using some plan, secret formula or process and therefore, these services rendered by the taxpayer were in the nature of technical services covered under article 12 of the DTAA. Accordingly, the AO considered such royalty receipts as income of the taxpayer. The CIT(A) held that since client coordination fees paid was not for the use or right to use any of the specified terms mentioned in the definition of 'Royalty' under article 12 of the DTAA, such fees can be taxed as business profits only. Further, as per article 7 of the DTAA, in the absence of PE in India the amount received by the taxpayer was not taxable in India.

The taxpayer contended that it was not having PE in India. Further it was acting as a communication agent by providing interface services which cannot be termed as 'technical services' and therefore it was not covered under the definition of 'Royalty'. Though the tax department claimed that the taxpayer was having PE in India, the AO in his assessment order had accepted that the taxpayer was not having PE in India. Accordingly, the client coordination fee earned by the taxpayer was not taxable in India.

Tribunal's ruling

The Tribunal observed that the AO had agreed that the taxpayer was not having a PE in India. Further the taxpayer did not produce any evidence which can prove that the taxpayer was having a PE in India. The Tribunal held that the taxpayer was not liable to pay tax on the client coordination fees since these services are not covered under the definition of 'Royalty' as observed by CIT(A).

26. DDIT v. Alcatel USA International Marketing Inc [2009-TIOL-733-ITAT-MUM]

The taxpayer, a non-resident company, was engaged in the business of developing designs, etc. The taxpayer entered into a contract for supply of

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software to an Indian company with a right to operate for its business purpose. The Indian company was also allowed to make copies of the software for its own internal operations. AO held that irrespective of whether the taxpayer retain ownership or grants user rights only to licensee, the amount received for permitting Indian company to utilise the computer software was taxable as 'royalty'.

CIT(A) observed that the Indian company acquired only a copy of software programme and did not acquire any copyright over such software. Accordingly, the CIT(A) held that amount received was only for purchase of copyrighted article which does not result into the payment for 'royalty' within the meaning of article 12(3) of the DTAA.

Issue before the Tribunal

Whether the payments made by Indian company amount to 'Royalty' within the meaning of article 12(3) of the DTAA?

The tax department placed reliance on the decision of the Supreme Court in the case of *TATA Consultancy Services*⁶² and contended that the software falls within the definition of 'goods' and hence there was transfer of rights in the software. The amount received by the taxpayer was 'royalty' payment towards transfer of goods.

The taxpayer placed reliance on decision of the Special Bench of the Delhi Tribunal in the case of *Motorola Inc., Ericsson Radio Systems AB and Nokia Corporation* and contended that the payment received by the taxpayer was not 'royalty'.

The taxpayer also placed reliance on decision of the Delhi Tribunal in the case of *Infrasoft Limited*⁶³ where it was held that the decision of the Supreme Court in the case of *TATA Consultancy Services* has limited application and the principle therein cannot be applied to the peculiar facts of the instant case and therefore, the payments received by the taxpayer cannot be termed as 'royalty' either under the Act or under the DTAA.

Tribunal's ruling

The Tribunal held that since the issue in the current case was squarely

⁶² *TATA Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 407 (SC) (LB)

⁶³ *Infrasoft Limited v. ADIT* [2009-TIOL-21-ITAT-DEL]

covered by the decision of the Special Bench of the Delhi Tribunal in the case of Motorola Inc., Ericsson Radio Systems AB and Nokia Corporation and in the absence of any contrary view taken with regards to the current issue, the payments received by the taxpayer cannot be termed as 'royalty' either under the Act or under the DTAA.

27. Dassault Systems K.K. [2010] 322 ITR 125 (AAR)

The applicant, a company incorporated in Japan, was engaged in the business of providing 'Products Lifecycle Management' (PLM) software solutions, applications and services. The applicant was promoting the licensed software products mostly through a distribution channel comprising of Value Added Resellers (VAR). The VARs, the independent third party resellers, are engaged in the business of selling software to end-users. The applicant entered into General VAR Agreement (GVA) with the VARs to authorise them to act as the reseller of products. As per the business model, the product is sold to VAR for a consideration based on the standard list price after deducting agreed discount. The VAR in turn will sell such product to the end-users at a price independently determined by them.

The end-user enters into End User License Agreement (EULA) with the applicant and VAR for the product supplied. The reseller (VAR) gets the order from end-user and places a back-to-back order on the applicant. On acceptance of the order by the applicant, it will provide a license key via e-mail so that the customer will directly download the product which was hosted on a server located outside India through the web link on its computer system/storage media. The VAR was prohibited from opening or using the product. After the download of the product, the end user will use the license key to activate the software and register the license. Such license key would be generated by the applicant to function only on customer's designated machine identified by internal code attached to their processor.

Issue before the AAR

Whether the payments received by the applicant on sale of software products are taxable as business profits under article 7 of the DTAA or 'royalty' as defined in article 12 of DTAA?

AAR's ruling

Whether income in the nature of 'Royalty'

- Computer software is embraced within the definition of literary work in the Indian Copyright Act. Even otherwise, the computer programme

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embedded in the software is a scientific work. Further, section 9(1)(vi) of the Act defines computer software. However, the ordinary meaning and understanding of computer software is no different.

- All intellectual property rights in the licensed programs exclusively belong to the applicant or its licensor and they are retained by the applicant, as per the explicit declaration in the Agreement. In order to see whether the applicant has transferred any rights related to copyright or conferred on the licensee/end-user the rights over the use of copyright, it is necessary to ascertain the true meaning of copyright and the incidents attached to it.
- In the case of *FactSet Research Systems Inc.* it was held that since the expression 'copyright' is not defined in the Act it must be understood in accordance with the law governing copyright in India, i.e. the Copyright Act, 1957. Accordingly, the tax department's contention that section 115A(1A) and section 9(1)(vi) of the Act controls the meaning of the term 'copyright' is not correct.
- Passing on a right to use and facilitating the use of a product for which the owner has a copyright is not the same thing as transferring or assigning rights in relation to the copyright. The enjoyment of some or all the rights of a copyright is necessary to trigger the royalty. However, non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in a copyright.
- Where the purpose of the licence or the transaction is only to establish access to the copyrighted product for internal business purpose, it cannot be held that the copyright itself has been transferred to any extent. It does not make any difference even if the computer programme passed on to the user is a highly specialized one. The parting of intellectual property rights inherent in and attached to the software product in favour of the licensee/customer is mandatory requirement by the Act and the DTAA to consider it as a 'royalty'.
- Accordingly, merely authorising or enabling a customer to have the benefit of data or instructions contained therein without any further right to deal with them independently does not amount to transfer of rights in relation to copyright or conferment of the right of using the copyright.

- The phrase “including the granting of a licence” in the definition of royalty under the Act, does not mean that even a non-exclusive licence permitting user for in-house purpose would be covered by that expression. It should take colour from the preceding expression “transfer of rights in respect of copyright”. Apparently, grant of ‘licence’ has been referred to in the definition to dispel the possible controversy a licence – whatever be its nature, can be characterised as transfer.
- The AAR observed that right to download the computer programme and storing it in the computer for his own use has not been passed on to the end-user⁴. The copying/reproduction or storage is only incidental to the facility extended to the customer to make use of the copyrighted product for his internal business purpose. Apart from such incidental facility, the customer has no right to deal with the product just as the owner would be in a position to do. Further, the licensed material reproduced or stored confined to the four corners of its business establishment on a non- exclusive basis will not attract section 14 of the Copyright Act. Otherwise, in respect of even off the shelf software available in the market, it can be very well said that the right of reproduction which is a facet of copyright vested with the owner is passed on to the customer. Such an inference leads to unintended and irrational results.
- Section 52(aa) of the Copyright Act makes it clear that the customisation or adaptation, irrespective of the degree, will not constitute ‘infringement’ as long as it is to ensure the utilisation of the computer program for the purpose for which it was supplied. Once there is no infringement, it is not possible to hold that there is transfer or licensing of ‘copyright’ since copyright is a negative right in the sense that it is a right prohibiting someone else to do an act without authorisation of the same by the owner.
- The AAR referred Copinger and Skone James treaties on Copyright (1999 Edition) where it was stated that, “the exclusive right to prevent copying or reproduction of a work is the most fundamental and historically oldest right of a copyright owner”.
- The AAR rejected tax department’s contention that the right to sell or offer for sale the applicant’s software product has been conferred on the VAR and therefore such authority given to VAR amounts to

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conferment of rights in or over the copyright. The AAR observed that the VAR has not been given an independent right to sell or offer for sale the software products of the applicant to the end-users. The VAR's role is only to forward the order to the applicant with the necessary documents. It is up to the applicant to accept it or not to accept it. Once the product is delivered to the end-user, the sale if any by VAR takes place simultaneously and that transaction is a different one. Accordingly, in the absence of an independent right to conclude the sale or offer for sale, the transaction cannot be regarded as 'royalty' under the Act or the DTAA.

- The AAR referred the Organization for Economic Co-operation and Development (OECD) commentary on Article 12 on this aspect and it observed that the analysis and reasoning reproduced above projects sound approach to the issue under consideration.
- Accordingly, the AAR based on the discussion reproduced above and after relying on various judicial pronouncements held that no rights in relation to copyright have been transferred nor any right of using the copyright as such has been conferred on the licensee.
- Further, the tax department's alternative contention to consider the payments received by the applicant as 'process' based on the decision of the special bench of the Delhi Tribunal in the case of New Skies Satellite Telecommunications Ltd. was not valid since the nature of operations involved in that case was different and not comparable to the software product with which it was concerned.
- The 'process' contemplated by the definition clause is broadly referable to know-how. The scope of preceding expression 'formula' too belongs to the same genus. By making use of or having access to the computer programs embedded in the software, it cannot be said that the customer is using the process that has gone into the end-product or that he acquired any rights in relation to the process as such. Nor can it be said that following the series of instructions so as to be able to effectively make use of the programs contained in the software amounts to the use of process or acquisition of any rights in relation thereto. The AAR without going into detail observed that much can be said against the view taken by the Tribunal in the case of New Skies Satellite case that the 'process' need not be secret and it can be

any kind of process, whereas the 'formula' should be in the domain of secrecy.

- Accordingly, the AAR held that the payments received by the applicant cannot be construed as 'royalty' taxable within the provisions of the Act or the DTAA.

On the formation of Agency PE

- The AAR observed that the business of VAR is not confined to the dealings only with the applicant and its products. They are appointed and known as distributors. It is common that a distributor carries out some functions and obligations similar to those of an agent. The business of the VAR is not controlled by the applicant except to the extent necessary to promote its own business. Further, the VAR does not negotiate or conclude contracts with the end-users on behalf of the applicant.
- The acceptance of the order placed by the end-user and procured by VAR is left to the discretion of the applicant. That authority is not delegated to VAR. Moreover, VAR is free to determine its own price while entering into the deal with the end-user on the acceptance of the order by the applicant. The restraints placed on VAR not to market or license competing products subject to certain exceptions is again not a factor that points to the existence of principal and agent relationship. Further, as per article 5(7)6 of the DTAA it is clear that the existence of an agent of independent status does not give rise to a PE.
- Accordingly, the AAR ruled that the payment received by the applicant from VARs on account of supplies of software products to the end-customers neither result in income in the nature of royalty nor business profits in the absence of PE as envisaged by article 7 of the DTAA.

28. CIT v. Samsung Electronics Co Ltd and others [2011-TII-43-HC-KAR-INTL]

The taxpayer imported off-the-shelf software from non-residents and made the payment for the same without deduction of tax at source on the basis that the payment does not constitute 'royalty' under the Act as well as under relevant tax treaty.

The AO treated the payment as royalty, both under the Act as well as under the relevant tax treaty and treated the taxpayer as an assessee in default for failure to deduct tax at source.

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In connection with the above, the Karnataka High Court, *inter alia*, observed and held as follows:

Copyright is an umbrella of many rights, and the license was granted for making use of the copyright in respect of the software. The end-user was authorised to make use of the copyrighted software which would amount to transfer of part of the copyright and the transfer of right to use the copyright

- The right to make a copy of the software and use it for internal business by making copy of the same and storing the same on the hard disk of the designated computer, and taking back up copy would itself amount to copyright work under Section 14(1) of the Copyright Act, 1957 (Copyright Act). The said activity would have constituted infringement but for the license granted.
- It is clear from the provisions of the Copyright Act that the right to copyright work would also constitute exclusive right of the copyright holder and any violation of the said right would amount to infringement under section 51 of the Copyright Act. Therefore, the contention of the taxpayer that there is no transfer of any part of copyright or copyright under the impugned agreements or licenses cannot be accepted.
- Therefore, the payment would constitute royalty within the meaning of the relevant tax treaty and the taxpayer was liable to deduct tax at source under section 195 of the Act.

Reliance cannot be placed on the decision in the case of Tata Consultancy Services v. State of Andhra Pradesh [2004] 271 ITR 401 (SC) since the question involved in said case was whether the transaction in question was sale for the purpose of Andhra Pradesh General Sales Tax, 1957.

29. CIT v. Wipro Ltd [2011-TII-45-HC-KAR-INTL]

The taxpayer made certain payments to a non-resident of USA for accessing its database which contained information concerning commercial, industrial or technical knowledge.

The tax department alleged that the payment made was in the nature of royalty, both under the Act as well as India-USA tax treaty.

The Karnataka High Court held that the right to access the database amounted to transfer of right to use the copyright. Further, the payment made by the taxpayer to the foreign publisher was for the license to use its database and therefore it should be treated as royalty.

The High Court relied on its own decision in the case of CIT v. Samsung Electronics Co Ltd and others [2011-TII-43-HC-KAR-INTL] and held that the payment for accessing database was in the nature of 'royalty'.

30. CIT v. Lucent Technologies (ITA No. 168 of 2004 and ITA No. 170 of 2004)

The taxpayer obtained orders from the Department of Telecommunications for the manufacture and supply of telecommunications/ switching equipments. In order to execute the order in India, the taxpayer imported software from Lucent Technologies USA (Lucent USA). They separately imported hardware from Lucent Technologies, Taiwan (Lucent Taiwan). The AO initiated proceedings under Section 201(1) and (1A) of the Act against the taxpayer for failure to deduct tax at source in respect of payment made to Lucent USA for the import of software. The CIT(A) held that the payments were made for supply of software and accordingly, the provisions of Section 9(1)(vi) of the Act read with the India-USA tax treaty was applicable.

The Tribunal held that the taxpayer purchased integrated equipments i.e. software from USA and hardware from Taiwan. The acquisition of software without hardware did not serve any purpose. The taxpayer had not acquired rights in the Copyright programme and hence the same could not be exploited commercially. Accordingly, the Tribunal held that the payment made by the taxpayer for acquiring the software could not be termed as royalty and no tax was required to be deducted under Section 195 of the Act.

High Court's ruling

The supply of software by Lucent USA to the taxpayer was an independent transaction. Only after receipt of both the software and the hardware, they have been integrated by the taxpayer in India and thereafter supplied to the Department of Tele Communications as an end product in terms of the taxpayer's independent contract.

In view of above the finding recorded by the Tribunal by examining the transactions of the taxpayer was erroneous. Consequently, the payments made by the taxpayer amounts to royalty and was liable to be taxed in India under Section 9(1)(vi) of the Act read with the tax treaty.

Further, the High Court observed that the CIT(A) held that the second proviso to Section 9(1)(vi) of the Act which restricts the scope of the section was not applicable as the taxpayer had not obtained any approval as required by the said proviso.

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The High Court held that the Tribunal committed an error in looking into the contract between the taxpayer and the telecom department and did not give any importance to the contract entered into between the taxpayer and Lucent, USA and Lucent, Taiwan.

It is clear that the Parliament was aware of the import of software both independently and under an integrated system. Therefore in view of the proviso to Section 9(1)(vi) of the Act, the amount paid by the taxpayer to the foreign software suppliers was 'royalty'. Accordingly, the taxpayer was required to deduct tax on the same.

31. ADIT v. Warner Brother Pictures Inc [2012] 49 SOT 438 (Mum)

The taxpayer is a foreign company engaged in the business of production and distribution of films. The taxpayer entered into an agreement with Warner Bros Pictures (India) Pvt Ltd (WBPI). The taxpayer granted exclusive rights of distribution of cinematographic films on payment of royalty. During the year under consideration the taxpayer received royalty pursuant to an agreement. The taxpayer claimed that the amount received from WBPI is not taxable as royalty in India either under the Act or tax treaty. However, the AO rejected the claim of the taxpayer and assessed the income at the rate of 15 percent as royalty under Article 12(2) of the tax treaty. The CIT(A) held that since the royalty is not specifically exempted under any provision of the Act, the same is covered by the general provision under Section 9(1)(i) of the Act. Further the taxpayer does not have a PE in India, the amount received by it is not taxable in India.

Issue before the Tribunal

Whether the payment to a foreign company for the distribution of cinematographic films is taxable as royalty under the Act or tax treaty?

Tribunal's ruling

On Royalty income

There is no dispute that the taxpayer has entered into an agreement with WBPI outside India and the amounts were also received outside India. Further the definition of royalty under Explanation 2(v) to Section 9(1)(vi) of the Act excludes the payment received with reference to sale, distribution and exhibition of cinematographic films. There is also no dispute that the provisions of the tax treaty do not include payment of any gain received as consideration for the use of any copyright or literary, artistic or scientific work

including cinematographic films or work on films, tape or other means of production for use in connection with Radio or T.V. broadcasting.

In view of these specific provisions provided under the Act and tax treaty, the amount received by the taxpayer could not be treated as royalty under the Article 12(2) of the tax treaty. Accordingly, the payment received cannot be brought to tax under the Act or tax treaty.

On Agency PE

Even if income arises to a non-resident due to the business connection in India, the income accruing or arising out of such business connection can only be taxed to the extent of the activities attributed to a PE. The taxpayer does not have any PE in India since the Indian company who obtained the rights is acting independently. Accordingly, agency PE provisions were not applicable.

The Tribunal reiterated the decision of Ishikawajima-Harima Heavy Industries Ltd⁶⁴ relied by the taxpayer and held that incomes arising to a non-resident cannot be taxed as business income in India without a PE. Accordingly, the income arising outside the Indian Territories could not be brought to tax.

32. Atlas Copco AB of Sweden v. CIT [2012] 205 TAXMAN 5 (Bom)

The taxpayer, a non-resident Swedish company, entered into an agreement with Atlas Copco (India) Ltd. for supply of the technical know-how for the manufacture of screw type air compressors and to render technical assistance that may be required during the existence of the agreement. The taxpayer was of the opinion that consideration received was not taxable in India as per the provisions of the India-Sweden tax treaty (tax treaty). The Assessing Officer (AO) held that the amount received by the taxpayer was royalty under the tax treaty and therefore, taxable in India. The said order was confirmed by the Commissioner of Income-tax (Appeals) [CIT(A)] and also by the Income-tax Appellate Tribunal (the Tribunal).

Issue before the High Court

Whether the amount received by the taxpayer on account of right to use the know-how for a specified period is taxable as royalty?

⁶⁴ Ishikawajima-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)

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High Court ruling

The High Court relied on the findings of the Tribunal and held that as per the agreement, the amounts were paid to the taxpayer on account of right to use the know-how for a specified period and there was no outright transfer of know-how by the taxpayer.

The taxpayer retained all the rights in the know-how to itself and only the limited right to use the know-how was parted with. Therefore, the amount received was royalty for giving the right to use the know-how for the limited period.

The High Court observed that as per the tax treaty any amount received by the taxpayer for allowing the right to use the know-how constitutes 'royalty' and would be taxable in India. Since the taxpayer received the amount on account of permitting the Indian company to use its know-how for the period specified in the agreement, it would get covered under the tax treaty and therefore taxable as royalty.

33. Pizza Hut International LLC v. DDIT [2012] 54 SOT 425 (Del)

In the return of income filed, the taxpayer claimed that its income was taxable at the rate of 15 percent under the tax treaty. The AO noted that the taxpayer had claimed exemption under Section 10(6A) of the Act in respect of tax on royalty borne by YUM. The AO was of the opinion that the assessment has to be made either in accordance with the provisions contained in the Act or in the tax treaty. The taxpayer cannot avail the exemption under Section 10(6A) of the Act and at the same time claim that tax should be levied at the rate of 15 percent under the tax treaty. Since the taxpayer claimed the exemption, the income should be taxed at the rate of 20 percent as provided in the Act. The CIT(A) held that the taxpayer was qualified for exemption under Section 10(6A) of the Act.

Tribunal's ruling

Taxability of royalty on 'gross basis' or 'net basis'

- The term 'gross amounts' has not been defined in the treaty. In common parlance, these words mean the amount received along with tax deducted at source. If the intention was to tax only that amount which is actually paid to the taxpayer, then the word 'amount' only would have been used. Therefore, it was clear that the intention was to tax the 'gross amount' and not the net amount of the royalty.

- The said term has not been defined in the tax treaty. Therefore, the guidance will have to be sought, if available, from the Act. Reiterating Section 198 of the Act, the Tribunal held that it embodies in itself the principle that tax deducted at source, for which credit is available to the payee, was nothing but payment of income, utilised for payment of tax on behalf of the payee. Therefore, this section also embodies the principle of ascertaining the gross amount paid by the payer to the payee.
- In terms of this provision also, the gross amount would mean the actual payment by way of royalty and tax deducted at source, paid to the Central Government on behalf of the payee. The amount of tax deducted at source would not be excluded from the total income under Section 10(6A) of the Act as no computation is required for finding the 'gross amount' of royalties paid to the taxpayer.
- The term gross amount includes within its ambit the actual payment and tax deducted at source or paid to the Central Government on behalf of the taxpayer. Therefore, the order of the CIT(A) was reversed on this issue.

Taxability of royalty on cash basis or mercantile basis

- The Tribunal relied on CSC Technology Singapore Pte. Ltd.⁶⁵ and observed that as per Article 12(1) of the tax treaty the initial point of taxation is the arising of the royalty in India, but it is finally taxed on the basis of amount of royalty paid to the non-resident. Accordingly, it was held that irrespective of the system of accounting, royalties are taxable on cash basis.
- The Tribunal held that what is important to note is that royalty for specific period had not been paid. Since royalties are taxable on cash basis, it is not necessary to go into press note No. 8 (2000) relied upon by the taxpayer and press note No. 9 (2000) relied upon by the tax department.
- Accordingly, it was held that the amount provided by the licensee in its books of account but not paid to the taxpayer was not taxable.

⁶⁵ CSC Technology Singapore Pte. Ltd. v. ADIT [2012] 50 SOT 399 (Del)

34. CIT v. Synopsys International Old Ltd [2012] 28 taxmann.com 162 (Kar)

The taxpayer, a tax resident of Ireland, was a subsidiary of Synopsys US. The taxpayer entered into a Technical License Agreement (TLA) with Synopsys US wherein Synopsys US granted a license to the taxpayer for using and commercially exploiting the intellectual property in the Electronic Design Automation (EDA) Tool and Software in certain geographies. Synopsys US was the owner of the copyright in the EDA software. Synopsys US specifically required the taxpayer to enter into End User License Agreement (EULA) with the customers to protect its right in the product, documentation and the intellectual property in the software.

The taxpayer received certain payments from its Indian customers for supply of the aforesaid software. The Assessing Officer (AO) treated the receipts as 'royalty' under Section 9(1)(vi) of the Act as well as under Article 12 of the tax treaty. The taxpayer, aggrieved by the order, preferred an appeal before the CIT(A) who confirmed the order of the AO. The Tribunal relying on the decisions in the case of Samsung Electronics Company Ltd.⁶⁶ and Motorola Inc⁶⁷ ruled in favour of the taxpayer by holding that the payment for purchase of EDA software did not amount to 'royalty' against which the tax department preferred an appeal before the High Court.

High Court's ruling

- The High Court has held that the decisions relied upon by the taxpayer dealt with the issue as to whether there was a transfer of a right in the copyright or transfer of a right in a copyrighted article. However, the question for consideration in the instant case was whether the sum paid to the owner/ licensor of a copyright, for permission to use the software/computer programme was a consideration for transfer of any right in respect of a copyright and fell within the mischief of the definition of 'royalty' (which were not dealt with in the decisions relied upon by the taxpayer).
- If the consideration does not fall within the definition of capital gains or within the second proviso to Section 9(1)(vi) of the Act, then the consideration would be 'royalty' under Explanation 2(v) to Section 9(1)(vi) of the Act.

⁶⁶ Samsung Electronics Company Ltd v. ITO [2005] 94 ITD 91 (Bang)

⁶⁷ Motorola Inc. v. DCIT [2005] 95 ITD 269 (Delhi)(SB)

- In respect of a copyrighted article, the right in the copyright was not transferred but a right in respect of a copyright contained in the copyrighted article was transferred. Therefore, the words 'in respect of' assumes importance for the proper understanding of what the Legislature meant in defining 'royalty' as they have done in Explanation 2 to Section 9(1)(vi) of the Act.
- The words 'in respect of' denotes the intention of the Parliament to give a broader meaning and admits of a wider connotation, than the word 'in' or 'on'. The expression 'in respect of' means 'attributable to'.
- The expression 'Copyright' used in the Copyright Act, 1957 (Copyright Act), cannot be used for the purposes of the Act. When the legislature advisedly used the word 'in respect of a copyright' in Explanation 2 to Section 9(1)(vi) of the Act, it cannot be construed as a right in the copyright and be assigned the meaning as given in the Copyright Act.
- Payments made for the acquisition of partial rights in the copyright without the transfer fully alienating the copyright rights will represent a 'royalty' where the consideration is for granting of rights to use the programme in a manner that would, without such license, constitute an infringement of copyright. In these circumstances, the payments were for the right to use the copyright in the programme i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder.
- To constitute 'royalty' under the Act, it is not necessary that there should be transfer of exclusive right in copyright, it is sufficient if there is transfer of any interest in the right and a license is given for consideration. It is in this background, the discussion whether the payment was for a copyright or for a copyright article would be totally irrelevant.
- The crux of the issue is whether any consideration was paid for any right or for granting of licence in respect of a copyright. The word 'in respect of' gives a broader meaning. It has been used in the sense of being connected with. When the legislature had advisedly used the words 'in respect of', the intention is clear and manifest. The said phrase being capable of a broader meaning, the same is used in the Section to bring within the tax net all the income from the transfer of all or any of the rights in respect of the copyright.

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- Copying includes the making of copies. Since in virtually every case the operation of a program in a computer involves the copying of the program within the computer, this will constitute reproduction. A software license can therefore be legitimately considered to be a copyright license.
- Merely because the end user is not permitted to make commercial use of a copyrighted article by means of reproduction of copyrighted article, it would not take the case out of the definition of 'royalty' in Explanation 2 to Section 9(1)(vi) of the Act. The use may be for personal use or for commercial use. The essence of the copyright is the usefulness of the intellectual property embedded in such copyright.
- The right to use intellectual property in respect of which the owner or the licensor possess a copyright is also a right in respect of a copyright, though not in the copyright itself. Therefore, the term 'in respect of a copyright' in Section 9(1)(vi) of the Act includes right to use the intellectual property in respect of which the owner or the licensor possess copyright. Therefore, it falls within the mischief of the word 'royalty' as defined under Section 9(1)(vi) of the Act.
- Merely because the words non-exclusive and non-transferable were used in the EULA, it did not take away the software out of the definition of copyright. Based on the EULA, even if exclusive right in copyright was not transferred, the right to use confidential information embedded in the software makes it abundantly clear that there was transfer of certain rights which the owner of copyright possess in the said computer software/program in respect of the copyright owned.
- It is not necessary that there should be a transfer of exclusive right in the copyright as contended by the taxpayer. The consideration paid was for rights in respect of the copyright and for the use of the confidential information embedded in the software/computer programme. Therefore, it falls within the mischief of Explanation 2(v) to Section 9(1)(vi) of the Act and there was a liability to pay the tax.
- The Parliament by the Finance Act, 2010, has substituted the Explanation to Section 9 of the Act which gives a clear intention of the Legislature insofar as the liability of tax under this provision is concerned. By the Explanation, the Legislature have declared that for the purpose of Section 9 of the Act which deals with income deemed

to accrue or arise in India, under Section 9(1)(v), (vi) and (vii) of the Act, such income shall be included in the total income of the non-resident, whether or not

- the non-resident has a residence or place of business or business connection in India; and
- the non-resident has rendered services in India.

Therefore, the object is to levy tax on the income of a non-resident, if it has accrued or arisen in India and one such income is the income from 'royalty'.

- In the tax treaty, the term 'royalty' means payment of any kind received as a consideration for the use or the right to use any copyright of literary, artistic or scientific work. Therefore, under the tax treaty, it is sufficient if the consideration is received for use of or the right to use any copyright.
- Further the High Court also held that, in terms of the tax treaty, the consideration paid for the use or right to use the said confidential information in the form of computer programme software itself constitutes 'royalty' and attracts tax. Therefore, the consideration is taxable as 'royalty' both under the Act as well as the tax treaty.

35. DDIT v. Rio Tinto Technical Services [2012] 340 ITR 507 (Del)

The taxpayer, a foreign company, had been operating in India through its division Rio Tinto Technical Services. It entered into an agreement with various persons for the evaluation of the resources to begin with a geological mapping, drilling and editing programme followed by iron ore quality testing and resource modeling. The taxpayer filed the income-tax returns in respect of three Assessment Years (AY).

The AO held that the payment received by the taxpayer from Rio Tinto India Private Limited (RTIPL) and Rio Tinto Orissa Mining Limited (RTOML) were taxable as FTS on gross basis under Section 44D of the Act. Further since FTS was taxable under the Act, the related tax treaty provisions were not applicable.

The Tribunal held that the contracts were inclusive contracts of technical nature, drilling, etc. It could not be said that the activities were purely technical in nature. The drilling and excavation and testing cannot be de-linked from the evaluation and the feasibility studies since it is a consolidated

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activity. Accordingly, the Tribunal held that the activities of the taxpayer could not be treated as FTS.

High Court's ruling

- It is not disputed that the taxpayer had a PE in India. If royalty arises through a PE situated in the contracting State, it would be taxable as business profits under Article 7 of the tax treaty and not as per Article 12 of the tax treaty.
- Under the Act business income in India is taxable under the chapter 'profits and gains of business or profession' which includes Section 44D of the Act which deals with computing income from royalty and FTS for Foreign companies. Section 44D of the Act begins with an overriding expression which states that other Sections of the chapter would not be applicable and deductions under those Sections cannot be allowed. For the purpose of Section 44D of the Act the expression of FTS and royalty are defined under the Explanation 2 of Section 9(1)(vi)/(vii) of the Act.
- The payment in the present case is for furnishing of evaluation report. The taxpayer has furnished technical information based on knowledge, experience and expertise gained by the taxpayer as a result of business or trading activity, etc.
- It would be immaterial whether the taxpayer had acquired and gained the said technical information because of business or trading activity or after conducting tests, mapping, etc. The nature and character of the information furnished for which the consideration received is the relevant criteria for deciding whether or not Explanation 2 to Section 9(1)(vii) of the Act is applicable. In the present case the fees was paid to acquire technical and managerial information.
- FTS under Section 9(1)(vii) of the Act excludes the consideration received from construction, assembly, mining or like project. When interpreted in a narrow manner the construction, assembly or mining activities may not strictly fall within and be regarded as the manufacturing, or trading activity.
- Use of the word 'project' in the said expression requires and mandates that there should be construction project, assembly project or a mining project or a like project undertaken by the recipient and the

consideration received should be on the said account. The clauses of the agreement do not disclose that the taxpayer undertook any mining project or a construction project. There was no such finding recorded by the Tribunal also.

- The High Court observed that the constitutional validity of Section 44D of the Act is not challenged and it cannot be examined. The Supreme Court in the case of A. Sanyasi Rao had drawn a distinction between foreign taxpayer and resident taxpayer as far as taxation on gross receipt basis was concerned. The tax rate under Section 44D of the Act is 20 percent, whereas tax rate at the normal rates in the years in question was much higher. In some cases, Section 44D of the Act may work to the advantage of the taxpayer and in other cases to the disadvantage of the taxpayer.
- The High Court held that Article 7 of the tax treaty applies to the taxpayer. However, on interpretation of paragraph 3 of Article 7, the provisions of the Act have to be examined to determine whether deduction of expenditure is permitted. Accordingly, Section 44D is applicable as the income earned by the taxpayer is taxable as FTS.

36. Shell India Markets Pvt. Ltd. [2012] 342 ITR 223 (AAR)

The applicant is an Indian company and has a network of retail fuel stations in India. Shell International Petroleum Company Ltd (SIPCL) is a Shell Group Company incorporated in UK. It is in the business of providing consultancy services to various Shell operating companies. The applicant has entered into a Cost Contribution Agreement (CCA) with SIPCL for the provision of Business Support Services (BSS). These services are primarily in the nature of management support services. Any research and development, technical advice and services may be provided by a separate arrangement. The specific BSS are provided on a specific request and are not subject matter of the questions raised in the present application.

According to the applicant, it is entitled to claim the benefit of the tax treaty since the contract being entered with a company incorporated in U.K. Therefore, the applicant relied on FTS provisions provided under Article 13(4) of the tax treaty to contend that the GBSS received from SIPCL does not 'make available' technical knowledge, experience, skill know-how or process, or consist of the development and transfer of a technical plan or technical design under Article 13(4)(c) of the tax treaty.

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AAR ruling

- The CCA provides examples of various services covered under GBSS. These examples exclude any research and development and technical advice and service which clearly indicates that the nature of the services are 'managerial services' and out of the purview Article 13(4) of the tax treaty.
- The activities under the agreement covers all types of activities with respect to all downstream products and chemical business carried on by the applicant. The services in the nature of 'Contract and Procurement' (C&P) would extend from creating, approval, confirmation of purchase order to the receipt of material, invoicing and payment release. These activities in a retail business are at the core of the retail marketing. The advice tendered in taking a decision which is of commercial in nature is a technical or consultancy service.
- The advice on information technology includes identifying opportunities for the applicant to successfully utilise cost advantaged locations and resources for application development. Thus, the services are of a highly specialised in nature and involve special knowledge of the applicant's business and industry.
- It cannot be denied that the applicant receives services in the form of general finance advice, taxation advice, legal advice, advice on information technology, media advice, assistance in contract and procurement and assistance in marketing. These advisory services would be consultancy services if the element of expertise or special knowledge on the part of the consultant is established. Accordingly, SIPCL, the consultant in the present case as it is engaged in the business of providing advice and services to various Shell operating companies.
- While explaining GBSS the word 'advice' is used very often. Under the CCA, the mode of providing GBSS are also 'through visits and other interchanges between members of the offices of the relevant staff' which is an important ingredient of consultancy services. The special knowledge and use of expertise on the part of SIPCL is clearly evident from the explanation of each service as is provided by the applicant. Therefore, the services being rendered are consultancy services.
- The agreement also covers certain other services like management

support, development, communication and audit of standards of performance and human resources but it cannot be denied that under an agreement, all the services come as a bundle and cannot be segregated. Accordingly, the nature of GBSS would be in the nature of consultancy services.

- As regards to the meaning of 'make available' in the MOU in India-USA tax treaty relied by the applicant, it may be noted that the tax treaty is a treaty entered into by two sovereign states relating to rights and duties of subjects or citizens of the respective States in one another's possession.
- It is noted that while describing the services, the term 'advise' has repeatedly been used and the services are themselves called 'support services'. This indicates that while providing GBSS, SIPCL works closely with the employees of the applicant and supports or advises them. Thus, GBSS 'made available' technical knowledge, skills, etc, to the applicant.
- The cost for Research & Development and Research & Promotional Activities shared among group entities are specifically excluded from CCA. Even if the provision of services does not involve element of profit, it would be taxable as FTS as held in *Timkin India*⁶⁸ and *International Hotel Licensing Company*⁶⁹.
- Accordingly, the payment made by the applicant to SIPCL for availing the GBSS under the CCA would constitute FTS within the meaning of Article 13(4)(c) of the tax treaty and not in the nature of 'royalty' within the meaning of the Explanation 2 to Section 9(1)(vi) of the Act and under Article 13 of the tax treaty. Accordingly, the applicant was under obligation to withhold tax under Section 195 of the Act.

37. UPS SCS (Asia) Ltd v. ADIT [2012] 50 SOT 268 (Mum)

The taxpayer is a non-resident company incorporated in Hongkong and inter alia engaged in the provision of freight forwarding and logistic services. It entered into a Regional Transportation and Service Agreement (the agreement) with an Indian company for providing freight and logistic service to each other in respect of import and export of consignments. Under the

⁶⁸ *Timkin India Ltd* [2005] 273 ITR 67 (AAR)

⁶⁹ *International Hotel Licensing Company* [2007] 288 ITR 534 (AAR)

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Agreement, the Indian company undertook to perform destination services on arrival of consignment to India which included local unloading and loading, local custom clearance, ground documentation and local transportation while the taxpayer undertook to perform the destination services outside India similar to those performed by the Indian company. During the year in appeal the taxpayer earned international transportation fees from the Indian company towards aforesaid services rendered by it abroad on export consignments which was claimed as non-chargeable to tax by the taxpayer.

Tribunal's Ruling

- The Tribunal held that International freight forwarding and logistic services performed by the non-resident outside India is neither Managerial, nor Technical nor Consultancy in nature and hence would not be taxable as FTS under Section 9(1)(vii) of the Act. Further, the Tribunal held that as the services were rendered outside India the same will not fall within the scope of Section 9(1)(i) of the Act.
- The key observations of the Tribunal while arriving at aforesaid conclusion are as under:
 - **Managerial Service**
 - The Managerial services contemplate not only execution but also the planning part of the activity to be done. If the overall planning aspect is missing and one has to follow a direction from the other for executing particular job, it cannot be said that the former is managing that affair.
 - In absence of any specific definition of the phrase 'managerial services' as used in Section 9(1)(vii) of the Act, it needs to be considered in a commercial sense. It cannot be interpreted in a narrow sense to mean simply executing the directions of the other for doing a specific task. The role of the taxpayer in the entire transaction was to perform only the custom clearance and transportation to the ultimate customer outside India. Accordingly, such restricted services cannot be characterized as managerial services.
 - **Consultancy Service**
 - The word 'consultancy' means giving some sort of consultation de hors the performance or the execution of any work. It is only

when some consideration is given for rendering some advice or opinion etc. that the same falls within the scope of 'consultancy services'. The word 'consultancy' excludes actual 'execution'.

- The nature of services, being freight and logistics services provided by the taxpayer to the Indian company has not been disputed by the authorities below. There is nothing like giving any consultation worth the name. Rather such payment is wholly and exclusively for the execution in the shape of transport, procurement, customs clearance, delivery, warehousing and picking up services. Accordingly the payment in lieu of freight and logistics services cannot be ranked as consultancy services.

➤ **Technical Service**

- The word 'technical' has been sandwiched between the words 'managerial' and 'consultancy' in Explanation 2 to Section 9(1)(vii) of the Act and since no definition has been assigned to the 'technical' services in the relevant provision, the same needs to be ascertained from the overall meaning of the words 'managerial' and 'consultancy' services by applying the principle of *notitur a sociis*.
- As the 'managerial services' and 'consultancy services' presuppose some sort of direct human involvement, technical services similarly cannot be conceived without the direct involvement of man. These services can be rendered with or without any equipment, but the human involvement is inevitable.
- Thus even if the view of the department that the computer was used in tracing the movement of the goods is accepted, such use of computer, though indirect, remote and not necessary, cannot bring the payment for freight and logistics services within the purview of 'technical services'. The essence of the consideration for the payment is rendering of services and not the use of computer.
- The decision in case of Blue Dart Express Limited would be of no support to the revenue since the ratio laid down in the case cannot be universally applied³ and there being material difference between the language of Section 9 (1)(vii) and 80-O of the Act.

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➤ Business Connection

- Explanation 1(a) to Section 9 of the Act makes it prominent that only that part of the income from business operations can be said to be accruing or arising in India, as is relatable to the carrying on of operations in India. In other words, if a non-resident earns any income from India by means of operations carried on outside India, that will not fall within the scope of Section 9(1)(i) of the Act .
- Since the taxpayer rendered 'International services' outside India which has not been disputed by the tax department there can be no question of roping such income within the ken of Section 9(1)(i) of the Act.
- Explanation below Section 9(2), relied on by the tax department, would be applicable only in respect of Section 9(1)(v) to (vii) of the Act. Section 9(1)(i) of the Act has not been included by the legislature within the ambit of Explanation, which shows that unless a non-resident earns income from business operations carried out in India, such income cannot be deemed as accruing or arising in India.

38. Global Industries Asia Pacific Pte. Ltd. v. DIT [2012] 343 ITR 253 (AAR)

The applicant is a Singapore Company and has a tax residency certificate issued by the Singapore tax authorities. During the FY 2008-09, the applicant has signed contracts with Indian Oil Corporation Ltd (IOCL) and Larsen & Toubro (L&T). The applicant does not have an office or any other premises in India for executing these contracts. The contract with the IOCL involves residual offshore construction work in the navigational waters of Paradip Port Trust, Orissa, installation of Single Point Mooring (SPM) including anchor chains, floating and subsea hoses. The applicant is of the view that its presence in India in the FY 2008-09 is only for 41 days and therefore there is no PE under the tax treaty.

The contract with L&T involves installation work in the waters of Mumbai High South field. During FY 2008-09, the applicant was present in India only for 119 days and in FY 2009-10 for 49 days. Therefore the applicant was of the view that it does not have PE in India. Alternatively, the applicant is of the view that if the benefits under the tax treaty are not granted then the receipts

are taxable under Section 44BB of the Act. The AO issued orders to withhold tax by treating the payments under the contract with IOCL as royalty under the Act as well as under Article 12 of the tax treaty by grossing up, and, the payments under the contract with L&T under Section 44BB of the Act.

Issues before the AAR

- Whether the services rendered by the applicant are in the nature of FTS / royalty?
- Whether the applicant has PE in India?
- Whether the income related to contract with L&T is taxable under Section 44BB of the Act?

AAR's ruling

Taxability of income from contract with IOCL

The AAR observed that contract with IOCL is not for installation alone. If during the activities of installation, income in the nature of royalty or FTS or interest or of any other nature arises, then such an income has to be assessed under that head of income. Further, IOCL is paying for each of the items separately, even though it is a composite contract.

The AAR relied on the decision in the case of Ishikawajima-Harima Heavy Industries Ltd.⁷⁰, where it was held that the consideration of each portion of the contract is separately specified and therefore it can be separated from the whole.

The AAR also relied on the decision of Richardson⁷¹ and held that from entire payment the payment for mobilization and de-mobilization is related to use of equipment for undertaking installation work and taxable as royalty under Article 12(3)(b) of the tax treaty.

Further, the part of entire payment relates to installation. As installation is ancillary and subsidiary to the use of equipment or enjoyment of the right for such use, the payment for installation is taxable as FTS as per Article 12(4)(a) of the tax treaty.

Taxability of income from contract with L&T

The Applicant and L&T were under negotiations with regard to the services

⁷⁰ Ishikawajima-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)

⁷¹ State of Madras v. Richardson & Cruddas Ltd. [1968] 21 STC 245 (SC)

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even prior to L&T entering into the contract with ONGC on 17 March 2008. On a perusal of contract it is clear that the services under the subcontract commenced not later than 23 April 2008, and continued even after the vessels left the shores of India in lieu of the services to be provided post-installation including surveys. Therefore, the applicant's contention of counting the duration of services from 3 December 2008 when the applicant's vessels were mobilised to India till 19 May 2009 when the vessels left the shores of India is untenable and unacceptable.

While the negotiations prior to 17 March 2008 can be termed as preliminary and can be ignored for the purposes of Article 5(5) of the tax treaty, the rest of the activities of the applicant including surveys, drawing, designs and getting materials ready and transportation are preparatory in nature. The duration of performing these preparatory activities cannot be excluded while calculating the duration of provision of services or facilities to determine the PE under Article 5(5) of the tax treaty.

Further Article 5(5) of the tax treaty is a deeming provision and its import is such that the said Article can be attracted even on provision of services without the presence of any building in the country in which services are provided.

Accordingly, the AAR held that the applicant has provided services or facilities in connection with the exploration, exploitation or extraction of mineral oils for more than 183 days during the FY. Therefore, the applicant has a PE in India under Article 5(5) of the tax treaty and covered by Section 44BB of the Act.

This ruling has been set aside by the Delhi High Court in the case of *Technip Singapore Pte. Ltd. vs. DIT (2016) 289 CTR 421 (Delhi)*. The Delhi High Court has stated the following:

- The revenue has been unable to counter the factual position that in terms of article 5(1) of the DTAA, the assessee has no fixed place of business in India. Under article 5(3) the assessee can be said to have a PE in India only if the installation or construction activity is carried on in India for a period exceeding 183 days in any fiscal year. The assessee was admittedly present in India only for 41 days during 2008-09 for rendering the contract of service to IOCL. The assessee also did not have a project office in India for executing the contract with IOCL.

- In terms of article 7 of the DTAA, the business profits earned by the assessee shall be liable to tax in India only if it carries on business in India through a PE in India and the profits earned by it in India are attributable to the activities carried out through such PE. Since factually the revenue was not able to show that the assessee had a PE in India, the income earned by the assessee from the contract with IOCL cannot be brought to tax in India in terms of article 7 of the DTAA.

39. Areva T & D India Limited [2012] 18 taxmann.com 171 (AAR)

Areva T & D SAS France (Areva France) is engaged in designing, engineering, manufacturing and supply of electric equipments that helps in transmission and distribution of power, commissioning and servicing of transmission and distribution system on turnkey basis. The applicant is a subsidiary of Areva France in India. Areva France is proposing to enter into an Information Technology Sharing Services Agreement (ITSA) with the applicant in order to provide support services in the area of information technology.

The support services would be worldwide network for data transfer between all group companies which will connect to all global applications of Areva France and intranet and internet traffic, messaging system for all e-mail communication between the subsidiaries and vendors, customers, etc.

Support services will be provided across the world from France and the consideration for availing these services will be apportioned to all subsidiaries.

The allocation key for determining the consideration would be based on the service provider's invoices, indirect cost based on IP Bandwidth license user rights and number of users per application for each of its subsidiary. The applicant is of the view that the services rendered by Areva France are merely supportive and co-ordinated in nature and do not impart any technical knowledge to the applicant.

AAR's ruling

- The AAR observed that the Model Commentary states that a PE may exist if the business of the enterprise is carried on mainly through automatic equipment and the activities of the personnel are restricted to setting up, operating, controlling and maintaining such equipment.

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Thus even existence of a computer server amounts to existence of a PE.

- The AAR on a perusal of UN Commentary (2001) observed that the place of business which includes equipment should be at the disposal of the foreign enterprise for the purpose of the business activities. Since there is no contractual relation between the applicant and other service provider, all equipment under the ITSA is at the disposal of Areva France.
- Further on a perusal of the book 'The Law and Practice of Tax Treaties: An Indian Perspective' (2008) the AAR held that since the tests of PE are satisfied, whether it is equipment leased or it is owned by the Areva France, will be of no consequence.
- Accordingly, the AAR held that the Areva France has a PE in India. Therefore, the payment by the applicant to the Areva France under the ITSA is to be treated as business income and liable to be taxed as per Article 7 of tax treaty.
- Under the ITSA, the Areva France is to provide support services through a central team in the area of information technology to the applicant and to its other subsidiaries in the world. The provision of support services by the Areva France would itself make available, the technical knowledge / experience to the applicant.
- Relying on the decision in the case of Perfetti Van Melle Holding B.V.⁷² the AAR held that the technology is made available to the applicant as the information technology provided is applied in running the business of the applicant and the employees of the applicant would get equipped to carry on these systems on their own without reference to the Areva France.
- Therefore, the AAR held that services provided under the ITSA are in the nature of FTS and taxable under the tax treaty as well as under the Act. Further as the Areva France has a PE in India, the income by way of FTS will be taxed under Section 44DA of the Act. The AAR observed that ITSA states that Areva France has the capacity and the resources to provide and co-ordinate IT Services to the Applicant. The AAR held that the payment was not in the nature of reimbursement.

⁷² Perfetti Van Melle Holding B.V. [2012] 204 Taxman 166 (AAR)

40. Hindustan Shipyard Ltd (Representative Assessee of FSUE, Rosoboronexport) v. ITO [2012-TII-04-ITAT-VIZAG-INTL]

The taxpayer is a foreign Company and it did not have any office or place of business in India. The taxpayer was having required expertise to carry out repair works of submarines. The Indian Navy with approval from the Government of India, entered into a service contract with HSL for medium repair and upgradation of its submarine with technical assistance and collaboration agreements. Subsequently, HSL entered into a contract with the taxpayer for elaboration and transfer of repair technical documentation to conduct medium repair cum modernisation.

As a 'representative assessee', HSL filed the income-tax return of the taxpayer for two assessment years. In these returns, the payment received from HSL was shown as business income and the entire payments were claimed as exempt on the ground that the technical documents provided falls within the category of 'Goods' and the transaction of sale was completed outside India. Accordingly, there was no tax liability on such sales. Further the return of income was processed and accepted. Subsequently, the AO re-opened the assessment after two years and treated the entire payments received by the taxpayer from HSL as FTS and determined the total income. The DRP upheld the order of the AO.

Tribunal's ruling

- Since the taxpayer is the recipient of the impugned amounts, there cannot be any dispute that the taxability of the same should be verified from the angle of the taxpayer. Further there is no dispute that the taxpayer was a non-resident. Thus, in case of a non-resident, any income which accrues or arises outside India is not taxable under the Act. However, under Section 9 of the Act certain types of income, which might have accrued or arose outside India, are deemed to accrue or arise in India.
- The status of HSL which has paid the impugned amounts to the taxpayer is a 'resident' under the Act. Accordingly, as per clause (b) of Section 9(1)(vii) of the Act, any income by way of FTS payable by HSL would deem to accrue or arise in India if the said payments were in respect of services utilised in a business or profession carried on by it in India. In the present case HSL has paid considerations to the taxpayer towards supply of 'Repair Technical documents' and

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'Detailed project report', which were utilised for the business carried on by HSL in India.

- If the technical documents supplied by the taxpayer were treated as 'Goods', then the payments received from HSL in that regard could not be treated as Indian income, as the transactions of purchase and sale have taken place outside the Indian territories. It is pertinent to note that the territorial jurisdiction to be seen in respect of a 'non-resident' shall not be applicable in respect of FTS as per the Explanation to Section 9(2) of the Act.
- The meaning of 'Goods' varies from statute to statute. The decision of Tata Consultancy Services relied by the taxpayer was rendered under A.P. General Sales tax Act for the purpose of determining whether the intellectual property reduced into a medium would fall in the category of 'Goods'. Therefore, the DRP was correct in holding that the decision of Tata Consultancy Services was rendered in a different context and did not support to the facts of the taxpayer.
- There is no dispute that the 'Detailed Project Report' and the 'Repair Technical Documents' were tailor made documents and specific documents prepared specially for the purposes of HSL. Further there is no dispute that the said assignment undertaken by taxpayer from HSL is a technical assignment. Accordingly, the payment received in that regard would not lose the character of FTS simply because of the fact that the said Detailed Project Report was received in the form bound volumes.
- The technical materials supplied by the taxpayer would not lose the characteristics of 'Service', simply because they were supplied in the form of bound manuals, more particularly when it is tailor made for the specific requirements of a person. The nature and substance of the transaction shall remain the same whether the assignment was given either by Indian Navy or HSL. Further a careful perusal of the agreement entered between the taxpayer and HSL would show that the impugned 'Repair Technical Documents' are not freely transferable.
- The Tribunal reiterated the decision of the DRP where it was held that the material submitted by the taxpayer shows that drawings and designs were passed on along with other technical information which

was essential for carrying out repair works on the submarine. The services were rendered separately by deputing personnel. Further there was no reason to split the transaction except for the purpose of tax. The personnel could not have carried out the repair works without the 'Repairs Technical Documents'. In so far as the technical information supplied was utilised in India, it would be taxable in India.

41. CSC Technology Singapore Pte Ltd v. ADIT [2012] 50 SOT 399 (Del)

The taxpayer, a Singapore company does not have PE in India. Its income consists of receipts from licensing of software to four customers in India. One among the four customers of the taxpayer is CSC India Pvt Ltd, a wholly owned subsidiary. Other three customers of the taxpayer are unrelated. SAP software is procured from an unrelated party and is internally used by all the group companies. The expenditure incurred for the use of the license by the group companies is shared on the basis of the extent of user. The whole of the payment for such software is made by the head office which is reimbursed on the basis of the bills raised by the head office and this amount was not included in the receipts. In respect of the user, RAS charges were paid by the head office. This expenditure is also spread over the user-group companies on the basis of actual user. The users reimburse the expenditure to head office on the basis of bills raised by it. These amounts are also not includible in the receipts of the taxpayer. Expenditure is also incurred on travelling in respect of employees of the head office who came to India for helping the work of the Indian subsidiary company. The Indian company has reimbursed this travelling expenditure to the head office on cost to cost basis. The taxpayer was of the view that the profit element is not included in the reimbursements and therefore, such reimbursements are not taxable.

The AO observed that the taxpayer has offered for taxation all payments received from India as royalty/FTS under the tax treaty. However, certain receipts were not offered for taxation. The amount paid by CSC India Pvt Ltd which pertains to the current year has been deferred to the next year. Accordingly, the difference in the amounts claimed by CSC India Pvt Ltd and offered to tax by the taxpayer had been added to the income of the taxpayer. The DRP upheld the order of the AO.

Tribunal's ruling

- The receipt of the taxpayer exceeds INR 4 million. Therefore, on a prima facie basis, it can be concluded that its accounts in respect of

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Indian operations are liable for audit under the Act. Although it was stated that it is liable to maintain accounts under Section 44AA of the Act, it has not been asserted that the accounts have been maintained. Further it is noted that the Indian subsidiary has claimed certain deduction of expenditure which was not offered by the taxpayer.

- The taxpayer is obliged to maintain India-specific accounts under Section 44AA of the Act and to get them audited under Section 44AB of the Act. Further being a company the accounts of the taxpayer are expected to be maintained on accrual basis in so far as provisions of the Act read with the provisions of the Companies Act are concerned.
- There is no doubt that the provision may be used as a device to defer the tax for any length of time by mutual understanding of the parties. However, to come to such a conclusion in a particular case, the conduct of the parties has to be seen and thereafter a conclusion has to be arrived that the deferment of payment was a device used for the purpose of delaying the payment of tax. There was no such finding has been recorded in this case. Therefore, royalty and FTS are taxable on payment basis and not on accrual basis.
- The reimbursements in respect of SAP licence and RAS charges are for the use of the licence belonging to a third party and getting the connectivity. The tax department has not been able to make that the said expenditure has been incurred in connection with earning of royalty/FTS. Accordingly, such income would be in the nature of business income. However, since the taxpayer does not have a PE in India, such business income is not taxable in India.
- The travelling expenditure has been incurred in connection with technical services agreement. In spite of the agreement provides adequate level of support and posting its personnel, the cost for which will be reimbursed to the taxpayer. This fact clearly indicates that such expenditure has been incurred for earning royalty/FTS.

42. Acclerys K K [AAR No 989 of 2010, dated 27 February 2012]

The applicant, a company incorporated in Japan, is a part of Acclerys Group of companies. It is a subsidiary of Acclerys USA, dealing in products of the Acclerys group in Asia. It has a LO in India and LO acts as a coordinator. Further, no sales are carried out through the LO. It is a scientific informatics software and services company which enables the customers to accelerate

their research process to enable them to rapidly discover new therapeutics materials and compounds and to introduce new efficiencies into the process that drive lower cost. The applicant has vast portfolio of copyrighted computer aided design modeling and stimulation offerings which assist customers in conducting scientific experiments in order to reduce the duration and cost of discovering and developing new drugs and materials. The product of the applicant are in a software form and the right to use the application is given to customers by way of vendor licence key and through an independent reseller in India for which the customers make a onetime payment.

To enable the sale of its products in India, the applicant entered into an arrangement with Apsara Innovations Pvt Ltd (Apsara Innovations). Apsara Innovations acts as a reseller of products and it quotes its own prices to the end users. Post acceptance of the terms and prices by the customers, reseller places purchase orders to the applicant. Thereafter, the license key is generated and delivered to the customer in India from overseas. The applications developed by the applicants are copyrighted material. It authorises the end users/customers to have benefit of the data, modules and applications contained in copyrighted products without any further right to deal with them independently. The license given to the customers is copyrighted material which is provided to the customers on a non-exclusive and non-transferable basis.

AAR ruling

- What is paid by a seller on behalf of the customer and what is paid by the customer direct, both partake the character of royalty. In the light of the ruling of Citrix Systems Asia Pacific Pty. Ltd⁷³, it does not appear to be necessary to further reason out the issue. The reasons given in the Citrix Ruling to find that what is paid by the reseller to the applicant is for updates and maintenance. Therefore it should be treated as royalty and not business income.
- Accordingly, the payment received by the applicant through an independent reseller in India cannot be treated as business income under Article 7 of the tax treaty. Further the payments received by the applicant from the sale of software products to the end users /

⁷³ Citrix Systems Asia Pacific Pty. Ltd (AAR/822 of 2009)

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customers through its independent reseller in India will be royalty as defined under Article 12 of the tax treaty. Therefore, tax needs to be deducted by the customers while making the remittances to the applicant.

43. Citrix Systems Asia Pacific Pty Limited v. DIT [2012] 343 ITR 1 (AAR)

The applicant, a company incorporated in Australia, is one of the leading providers of software services which help in virtualisation, networking and application delivery. It also offers a range of application collaboration, firewall, networking and streaming solutions. It entered into a distribution agreement with Ingram Micro India Limited (Ingram). Under an agreement, Ingram was appointed as a non-exclusive distributor of the products of the applicant in India. The software products are purchased by the distributor from the applicant and sold to the customer. With respect to the hardware products, the applicant shifted the products directly to the distributor which in turn supplied these products to re-sellers and end-user customers. However, for the software product, 'Citrix XenApp', while sale and collection is made through the distributor, no physical delivery of the product is made to the distributor.

On the basis of the demand of the customers, the distributor places purchase orders with the applicant and makes payments. The applicant then directly transmits a 'key' to the end-user customer who is required to download the XenApp software. On receipt of the key, the end-user customer downloads the software from the server of the applicant. Ingram owns the responsibility for collection of the price for the product from its customers. In addition to the distribution of hardware products and Citrix XenApp software under the distribution agreement, Ingram also facilitates the execution of the Citrix Subscription Advantage Programme between the applicant and its existing customers. The programme is offered by the applicant in the form of a package of support services during the period of the programme.

AAR ruling

- The Act or tax treaty does not define the term copyright. However, the Copyright Act provides the meaning of 'copyright' as an exclusive right subject to the provisions of the Copyright Act to do or authorise in doing of any of the acts referred to therein in respect of a work or any substantial part thereof. The definition of royalty under the Act refers to

transfer of all or any rights, including the granting of a license, in respect of the copyright. It does not refer the grant of any exclusive right. In fact, if one were to go by the provisions of the Copyright Act, the transfer of a copyright itself may be, whole or partial, general or subject to limitations or for the whole term of the copyright or any part thereof. Therefore, even a partial right or confined right granted to the assignee would attract the definition of royalty as found in the Act.

- The concept of conveying of exclusive right either by way of assignment or by way of license does not appear to be the *sine qua non* for coming within the definition of royalty under the Act or tax treaty. Whenever software is transferred or licensed for use, it falls within it the copyright embedded in the software and one cannot be divorced from the other. The AAR observed that the words 'including the granting of a license' indicate an expansive definition and it is a devise to bring in something which might not otherwise be included in the words used. A license is a mere permission or authority to do a particular thing, it is not a transfer, hence in addition to the words 'transfer of any rights', the Act brought in by way of inclusion, the words 'including the granting of a license'.
- The article under the tax treaty provides the term royalty as 'the use of or the right to use of any copyright'. Use of a copyright takes place, when the copyright is used. This is distinct from the right to use a copyright. The two expressions are used disjunctively and the expression used is 'or'. The context does not warrant the reading of 'or' as 'and'. Therefore, the consideration received for permitting another to use a copyright is also royalty.
- When a copyrighted article is permitted or licensed to be used for a fee, the permission involves not only the physical or electronic manifestation of a programme, but also the use of or the right to use the copyright embedded therein. Accordingly, the payment received for sale of the software product is in the nature of royalty under the Act as well as tax treaty. Further the payment received by way of Subscription for the updates would also be payment received for grant of a right to use the copyright embedded in the Subscription Advantage Programme and it is in the nature of royalty. Therefore, Ingram is required to withhold taxes in India under Section 195 of the Act. However, since the payment for Subscription Advantage

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Programme is in the nature of royalty, it is not necessary to rule on whether such payments would be in the nature of FTS under the Act.

44. Organisation Development Pte Ltd v. DDIT [2012] 50 SOT 421 (Chen)

The taxpayer, a company incorporated in Singapore, was providing services to various clients all over the world for development of BSC project. During the year under consideration it had rendered services to various companies located in India. The taxpayer was of the view that the receipts towards the services falls under business profits provided under Article 7 of the tax treaty and such business profits were not taxable in India in absence of PE. Accordingly, the taxpayer filed its income-tax return declaring nil income and claimed a tax refund. The taxpayer furnished copies of agreements entered with three of its clients in India to the AO. On a perusal of the agreements the AO divided services for development of BSC into two segments i.e. professional fees rendered to the clients and lump-sum amount received for sale of relevant software.

The AO held that receipt towards professional fees have to be treated as royalty under Section 9(1)(vi) of the Act. However, the payments could also be treated as FTS under Section (9)(1)(vii) of the Act. Further the lump-sum consideration received for the software designed for BSC was covered under the definition of 'royalty' under Section 9(1)(vi) of Act. The DRP upheld the order of the AO.

Tribunal's ruling

- On a perusal of the agreement it is clear that the taxpayer had sent its principal consultant with a team to help its clients in implementing a licensed software, which was required to develop the BSC for such clients. The clients were required to make lump-sum payments for downloading such software from the designated sites and such software was to be used in various phases of developing the BSC system.
- The most important step in evolved in a BSC system is identifying the measures that are to be used and a study by a trained expert for such identification based on the destination statements. The measures will vary from organisation to organisation, because any two organisations rarely have same destination statements.

- Further each client has its own goals and different strategies to reach such goals. The measures will also be different. A team, which is evolving a BSC system necessarily, has to identify the measures that are relatable to the entity under study. Therefore, it could not be said that this is a type of service which can be used by any organisation by application of an off the shelf software.
- The software is only a part of the total process for development of BSC. The fees received by the taxpayer have been linked to the downloading of the software but that would not be sufficient to come to a conclusion that the software is an equipment by itself from which the taxpayer could earn royalty. Further, the whole process could not have been divided into two services i.e. royalty and FTS, just on the basis of a clause contained in the agreement.
- The software used by the taxpayer is not independent but only a part of the services rendered by the taxpayer to its clients with regard to the development of BSC. Accordingly, by means of BSC system developed by the taxpayer, the clients were getting an advantage which went much beyond the period of agreement between the taxpayer and its clients.
- The BSC enabled the clients to acquire the skills necessary for implementing their business strategies more effectively. The taxpayer had made available technical knowledge and skill which enabled its clients to acquire the knowledge for using BSC system for their business purposes for meeting their long-term targets and the benefits ran well into the future.
- To fit into the terminology 'the technical knowledge, skill, etc, it shall remain with the person receiving the services even after the particular contract comes into end. BSC does not become useless and was meant for the use of the business needs of its clients even after the tenure of the agreement.
- The software was only a part of the tool of management consultancy and was never to be considered as independent divorced of the total system. The technical knowledge and skill for use provided by the taxpayer remained with such clients. Thus, fees received for designing of the management tool called BSC will definitely fall within the definition of FTS as provided under Article 12(4) of the tax treaty.

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45. ITO v. People Interactive (I) P Ltd [ITA Nos. 2180, 2179, 2181, 2182, dated 29 February 2012]

The taxpayer is owner/host of website www.shaadhi.com where individuals can register and exchange the relevant information for matrimonial alliances on payment of appropriate subscription amount. This facility is available to the residents as well as non-residents. The taxpayer availed the services of Rackspace Inc, USA vide service agreement.

The Rackspace Inc. offered advanced type of dedicated hosting solution to the taxpayer and the services provided are categorised as server management, bandwidth and connectivity, security. Rackspace provides very high level of security for the data stored on the servers including backups and restorations, firewalls, intrusion detection, protection from Trojans, worms, etc. The taxpayer paid USD 31917 under the head 'computer and IT services' to Rackspace Inc. However, the tax has not been deducted while making payments since the taxpayer was of the view that such payments were in the nature of business income and in absence of a PE it is not taxable under Article 7 of the tax treaty.

The AO held that Rackspace Inc. has given right to use the server to the taxpayer along with account manager and business development consultant in relation to its activities. Therefore, the payment made by the taxpayer to Rackspace Inc. falls under the definition of Royalty under the Act as well as under the tax treaty. The CIT(A) observed that Rackspace Inc is providing hosting services to the taxpayer and not given any equipment on hire. Accordingly, following the order of the Tribunal in the case of Kotak Mahindra Primus Ltd⁷⁴ as well as the ruling in the case of ISRO Satellite Centre⁷⁵ it was held that the payment was not taxable.

Tribunal's ruling

- On a perusal of the agreement it is clear that payments were made for providing web hosting services with all backup, security, maintenance and uninterrupted services. There is no dispute that all the equipments and machines relating to the services provided to the taxpayer are under the control of Rackspace Inc and situated outside India.
- The Tribunal observed that the taxpayer could not operate or even

⁷⁴ Kotak Mahindra Primus Ltd v. DDIT [2007] 11 SOT 578 (Mum)

⁷⁵ ISRO Satellite Centre (ISAS) in re [2008] 307 ITR 59 (AAR)

does not have physical access to the equipments system which clearly indicates that the taxpayer would not be using the equipments but only availing the services provided by Rackspace Inc.

- The Tribunal relied on the Delhi High Court's decision in the case of Asia Satellite Telecommunications Co. Ltd. and held that when the equipments were not operated, used or under the control of the taxpayer, the payments made for availing the services of Rackspace Inc. could not be treated as royalty. When the payments are not in the nature of royalty as per the tax treaty and under the Act, the recipient of the said payments which does not have PE is not liable to tax in India.
- When payments are not in the nature of royalty as per the tax treaty and as per the Act, the recipient of the payment being a non-resident which does not have PE in India is not liable to tax. Accordingly, tax withholding is not required under Section 195 of the Act in view of the Supreme Court's decision in the case of GE India Technology Centre P. Ltd⁷⁶.

46. XYZ Ltd [2012] 348 ITR 20 (AAR)

The applicant, a tax resident of Hong Kong, belongs to X group of companies. The parent company ABC is having its headquarters in A Country. The group entities are engaged in the business of IVTC services to various customers. The X Trademark is owned by ABC, who had entered into a Trademark License and Support Services Agreement (Support Services Agreement) with all its group entities. The Support Service Agreement aims at bringing uniform standards, procedures and policies to IVTC Services.

The IVTC services are provided to the Indian customer outside India if there is a direct arrangement between the customer and the applicant and the payment is made on the invoice raised by the applicant. But when the arrangement is not direct and is through the X India, then the invoice is raised either on X India or the Indian customer.

AAR's Ruling

- When a customer desires to obtain any services, X discusses the scope of services, the procedure to be adopted, the billing charges

⁷⁶ GE India Technology Centre P. Ltd v. CIT [2010] 327 ITR 456 (SC)

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and preparation of invoice and the sharing of inspection fee with the supplier/receiver. Upon finalisation, a surveyor/inspector is appointed depending on the nature of the product/activity, the inspection is carried out and a report is prepared.

- The applicant renders technical service by carrying out tests and certifying that the goods imported /exported conform to certain specifications. The AAR relied on various decisions⁷⁷ and concluded that services performed by the applicant i.e. Inspection and survey of imported/exported cargo and certifying in relation to quality and price, laboratory testing, certification services for assuring quality, testing of samples, rendering technical assistance in preparation of project reports are 'technical services'.
- Reports are produced by experienced surveyors, coordinators, chemists and inspectors. The reports are highly technical in nature and help the customers to protect their immediate and long term financial interests during cargo loading/unloading and storage, transport custody and other business activities. The purpose for which the report is prepared is not diluted or perishes after evaluating the quality and quantity of the cargo/product, but is useful to evaluate contracts to secure maximum commercial value for each deal, post deal reconciliation, demurrage calculation and negotiations.
- The reports are customised services and not routine commercial services. Thus, the technical services provided to the customers/X India is covered under the term FTS under Section 9(1)(vii) of the Act. The exception provided under Section 9(1)(vii)(b) of the Act is not available to the applicant.
- The expenditure incurred, whether in the form of reimbursement or sharing administrative cost are in connection with the provision of

⁷⁷ Overseas Merchandise Inspection Company India(P)Ltd. [2002] 80 ITD 176
Searle(India)Ltd. v. CBDT [1984] 145 ITR 673 (Bom)
NQA Quality Systems Registrar Ltd. v. DCIT [2005] 92 TTJ 946 (Del)
Cochin Refineries Ltd. v. CIT [1996] 222 ITR 354 (Ker)
Union Carbide Corpn. v. Inspecting Assistant Commissioner [1994] 50 ITD 437 (Cal)
Central Mine Planning & Design Institute Ltd. v. DCIT [1998] 67 ITD 195 (Pat)

IVTC Services and therefore it makes no difference whether such expenditure is included in the fee or charged separately. The employees are seconded to render services and the expenditure is wholly and exclusively laid out to perform the IVTC Services. The AAR held that the expenditure incurred bear the same character as FTS even when it does not involve any element of profit and are chargeable to tax under Section 9(1)(vii) of the Act. The AAR distinguished the decision in the case of Aktiengesellschaft of the basis of facts.

- As the applicant has tax presence in India, X India / Indian customers are required to withhold taxes under Section 195 of the Act. Further, as the applicant has taxable income in India, it is required to file tax return under the provision of Section 139 of the Act.

47. Mersen India Private Limited [2012] 249 CTR 345 (AAR)

The applicant, an Indian company, is a 100 percent subsidiary of a French company. The French company in turn has another 100 percent subsidiary incorporated in France. The applicant and its parent company in France are both in the business of manufacturing electrical components. The applicant entered into a 'Services Agreement' with the French company. Under the services agreement, the French company has undertaken to provide services in the nature of assistance, professional and administrative consultation and training to the applicant. The applicant has to pay the expenditure incurred by French company for the services rendered to the applicant plus 5 percent of that amount. The invoice was to be in Euro and the money had to be remitted to a bank in France. The payment had to be made free of and without withholding taxes and duties and other charges and if such withholding was necessary, the same had to be borne by the applicant and there could be no deduction from the amount to be paid to the French company.

The applicant had also entered into another agreement with French company wherein French company had undertaken transactions in the nature of E-Sourcing, Mail messaging, ERP maintenance, etc. The applicant was not seeking an advance ruling in respect of that transaction. The applicant was seeking a ruling on the transaction evidenced by the services agreement.

AAR ruling

- The applicant did not dispute that the payment would be FTS under the Act. In spite of the USA tax treaty entered on 12 September 1989,

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preceding the signing of the French tax treaty, the language or scope of USA tax treaty was not adopted in the French tax treaty. If the intention was to adopt the USA tax treaty, there would have been no difficulty in adopting the relevant clause in the French tax treaty as well.

From the French tax treaty perspective, the bargaining countries adopted the definition as it is found in the tax treaty and parallel to one found in the Act. Surely, the intention must be not to adopt the concept as it is provided under the USA tax treaty. Further, the protocol also provides for adopting the scope of taxation from any other treaty entered into after 1 September 1989. It is strange that if the intention was to have an identical regime of taxation, and nothing is enacted in the Article in the French tax treaty along the same lines as one found in the USA tax treaty, why that intention was not given effect to.

- The copy of the protocol provided by the applicant and the publications available with us indicates the expression '*rate of scope*'. On a perusal of the clause as a whole, it would be appropriate to read the expression as '*rate or scope*' instead of '*rate of scope*' in the context. It is open to the AAR or a Court to 'iron out the creases' if warranted, to give a meaning to the provision. In view of this approach, both rate of taxation and scope of taxation are covered under clause 7 of the protocol to the French tax treaty.
- In the absence of a 'make available' clause under the French tax treaty, the concept of 'make available' can be borrowed from the USA tax treaty. However, this can be done only for technical and consultancy services which alone are embraced by the USA tax treaty and managerial services are left out from the concept of 'make available' from the USA tax treaty.
- Under Article 13 of the French tax treaty, there is no stipulation that managerial services should be made available before the consideration paid for it can be taxed. In other words, mere rendering of managerial services would invite tax liability in India for the consideration received for that service.
- On a reference to the areas covered by advice and assistance to be made by the French Company, it indicates that the advise and assistance pervades the entire business of the applicant. Under some

heads training is also imparted and therefore, the services are in the nature of technical, managerial and consultancy services. The services which relate to overall management and direction, marketing and managing the accounts and financial operations of the applicant are managerial services in nature which would fall within the meaning of Article 13 of the French tax treaty.

- The services rendered on marketing, on strategy and the training provided to optimise sales techniques would fall under consultancy services. Though on reading some of the items of advice and assistance, it may even be possible to say that technical services are also rendered. However, the predominant purpose of the services agreement appears to be to provide managerial and consultancy services.
- For taxation of managerial services under the French tax treaty, it is not necessary that such services make available under the expression as generally understood with reference to FTS Article. On the terms of the agreement, the services are made available so as to satisfy even that test. Therefore, the payments for managerial services are taxable under Article 13(4) of the French tax treaty.
- The advice and assistance rendered by the French Company to the applicant are not transient in nature and are capable of being used by the applicant on its own. The consultancy services are enduring and they help in promoting the business of the applicant. The employees of the applicant are in a position to use the knowledge in the business. Thus, knowledge and know-how are made available to the applicant. Therefore, the consultancy services are made available to the applicant.
- Accordingly, the French company is rendering managerial and consultancy services to the applicant. The managerial services are taxable under Article 13(4) of the French tax treaty. They are taxable even if one were to invoke the concept of 'make available'. However, the consultancy services provided are taxable under Article 13(4) of the French tax treaty read with Article 12(4) of the USA tax treaty. Accordingly, the applicant needs to withhold tax under Section 195(1) of the Act at the rate of 10 percent of gross amount of fees under Article 13(2) of the French tax treaty.

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- The payments in terms of the services agreement are not in the nature of business profits under Article 7 of the French tax treaty. Further the question of existence of a PE does not arise in view of the finding that the payments are liable to be taxed as FTS.

48. Armayesh Global v. ACIT [2012] 51 SOT 564 (Mum)

The taxpayer is engaged in the business of manufacturing and exporting of hand embroidery and handicraft items. The taxpayer had executed export sales in Australia, UK, USA, Italy and France and for procuring the export orders the taxpayer was using the services of overseas commission agent namely Indijack Ltd. Indijack Ltd either provides confirmed export orders or provides information regarding prospective customers. The agent is entitled to commission only on actual export sales executed for customers routed through Indijack Ltd. The taxpayer relied on CBDT Circular⁷⁸ which clarifies that no tax is deductible under Section 195 of the Act for expenditure towards export commission payable to a non-resident for services rendered outside of India.

Accordingly, the AO held that payments made to the Indijack Ltd. were covered under the 'managerial services' and is not in the nature of commission. Such payments to a non-resident is income deemed to accrue or arise in India under section 9(1)(vii) of the Act and since the taxpayer did not deduct tax, the payment needs to be disallowed under Section 40(a)(i) of the Act.

The CIT(A) held that the payment made to a foreign agent was a composite payment which needs to be treated as FTS since the payment has an element of income which was taxable in India. Therefore, the taxpayer needs to withhold tax.

Tribunal's ruling

- On a perusal of the agreement, it is pertinent to note that a foreign company was only acting as an agent on a commission basis and has not been providing any managerial or technical services. The agreement clearly shows that the foreign company was to get commission for promoting the products of the taxpayer and rendering incidental services on sales, such as recovery etc, for doing export

⁷⁸ CBDT Circular No. 23 dated 23 July 1969

sales.

- It is also responsibility of the foreign company to disseminate the information and inquire about various importers in various countries so that the taxpayer's exports can be increased. The foreign agent was responsible for arranging timely payment from the customers and commission was paid only after the sales amount was received. Since the services were rendered outside India, the provisions of Section 5 of the Act could not be applied to the commission paid.
- The definition of 'FTS' under the tax treaty does not include managerial services. Further, as the foreign company does not have any PE in India and the commission paid has to be considered as business income, it cannot be taxed in India as per the tax treaty. However, lower authorities have not considered the issue of the tax treaty, even though taxpayer mentioned the same in its submissions before the lower authorities.
- On a reference to Section 9(1)(vii)(b) of the Act, it is pertinent to note that fees payable for the purposes of making or earning income from any source outside India are not included in the income by way of FTS. This amount has to be considered as business income and since the services are rendered outside India, that amount is not taxable as it does not accrue or arise in India.
- Further, the agreement between the taxpayer and the non-resident is only for rendering services which cannot be considered as technical services and since there was no PE of the said non-resident agent in India, the amount does not accrue or arise in India. Therefore, there is no need to withhold tax under Section 195 of the Act and the same cannot be disallowed under Section 40(a)(i) of the Act.
- Since there is no evidence that the non-resident agent has rendered any managerial services to the taxpayer and the agreement indicates only services simplicitor for agency on commission basis, the findings of the lower authorities are to be rejected.
- As per the CBDT Circular 786 where a non-resident agent operates outside the country, no part of his income arises in India. In the present case also the payment was remitted directly abroad and it was not received by or on behalf of the agent in India. Therefore, tax withholding is not required under Section 195 of the Act on export

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commission and other related charges payable to a non-resident for services rendered outside India.

- Even though the CBDT Circular 786 has been withdrawn by CBDT Circular 7 with effect from 22 October 2009, the Circular 786 would continue to be applicable during Assessment Year 2007-08, i.e. the period under appeal as held by the Bombay High Court in the case of UTI. Accordingly, tax withholding is not applicable under Section 195 of the Act.

49. Thought Buzz Pvt. Ltd v. DIT [2012] 346 ITR 345 (AAR)

The applicant, a tax resident of Singapore is engaged in providing social media monitoring service for a company brand or product. Further it is a platform for users to hear and engage with their customers, brand ambassadors etc. on the internet. The applicant is wholly controlled and managed from Singapore where the company was incorporated. The applicant does not have a PE in India and all its directors are non-residents. The applicant offers services on charging a subscription. The clients who subscribe services of the applicant can login to its website to do a search on what is being spoken about various brands. The system operated by the applicant generates a report with analytics with inputs provided by the clients.

The information for generation of report is obtained from blogs and forum, social networking sites, review sites, question and answers sites and twitter. The applicant does not depend on third party application programme interface feeds for data collection and has its own crawlers³ for data extraction. The applicant also maps blog, forums, facebook posts and twitter users country wise to provide social media analytics for different markets. The subscription received from the provision of service is taxable as business income in Singapore.

AAR ruling

- On a perusal of the facts, it appears that the applicant is in the business of gathering, collating and making available or imparting information concerning industrial and commercial knowledge, experience and skill and consequently, the payment received from the subscriber would be in the nature of royalty in terms of clause (iv) of Explanation 2 to Section 9(1)(vi) of the Act.

- In view of the tax treaty, the subscription fee would qualify as royalty since it is for the use or right to use for consideration, the process or information concerning industrial, commercial or scientific experience. Therefore, the subscription fees received from the Indian subscriber would be treated as royalty under Article 12(2) of the tax treaty.
- Accordingly, the payment received from offering the particular subscription based service is taxable in India as 'royalty' under Article 12(2) of the tax treaty. Therefore, tax is required to be deducted from the payment made by the subscribers who are resident in India under Section 195 of the Act.

50. 'A' Systems [2012] 345 ITR 479 (AAR)

The applicant, a German company is engaged in the business of executing contracts for assembly and supervision of paint shop, including supply of materials and supervision of installation for various automobile companies. The applicant and its affiliates ('A' group of companies) have formulated a R&D policy and as per this policy, all R&D activities for the 'A' group of companies are coordinated through the applicant. 'A' entities, who wish to participate in the R&D, entered into a Agreement.

Cost Allocation Agreement (CAA) is described as a revised agreement which supersedes an earlier agreement. Altogether, 24 companies belonging to the group, including the applicant and the Indian subsidiary, are parties to the agreement. CAA provides that R&D will be undertaken by any or all parties with a stipulation that the applicant is the administrator under the agreement and the entire cost of the research is to be shared based on an allocation key. Further the participants are allowed a royalty-free unlimited access to the research results including any Intellectual Property Rights (IPRs) generated from the R&D. Though all are joint owners of the IPRs, the rights are registered in the name of the applicant.

AAR ruling

- The CAA contemplates the grant of rights to each other by the parties and right to exploit any technology developed under the agreement within their respective geographic regions. It also provides allocation of costs of the individual parties of the group. However, it does not provide a clear sharing of the R&D cost.
- Further, services are provided by one party to another party of the Agreement. While allocating costs, only those costs shall be taken into

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account which results from services rendered to the parties of this agreement. Therefore, incurring of costs depends on the receipt of services.

- What one has to look for is whether the parties share the costs of the 'R&D', the result of which is to be owned by all of them, irrespective of whether one uses it or not, before attributing common ownership. On the terms of the agreement, there is no direct provision indicating that the costs are shared by all the parties to the agreement.
- As per the CAA, the entire costs of the R&D undertaken are shared between 'A' entities participating in the CAA based on an allocation key. However, the term allocation key is not explained.
- Though the agreement asserts that the ownership of the products shall remain with all parties to the agreement, it is not clear on what consideration it happens. The contribution made by the user to the researching member cannot confer title to the research on all. Parties to the agreement individually spend on R&D and they allow the other parties to use the product of their research.
- A party not using the product of a particular research done by a member does not contribute towards the costs of research. Therefore, the sharing of cost of the R&D allocation key does not have any meaning.
- In the case of ABB Ltd, the parties who shared the research expenditure became the joint owners of the product which they were entitled to share without payment of royalty. The agreement in the case of ABB Ltd specifically provided that 'The total costs for corporate R&D shall be born by the parties in proportion to the value-add achieved by the parties'.
- However, in the instant case there is no similar cost sharing provision. Accordingly, the payment is made only when the product or process is used. Therefore, it is difficult to accept the submission that the parties to the agreement have become the joint owners of the product of the research. Hence, the ratio of ABB Ltd ruling is not applicable to the facts of the present case.
- The payment occurs only when the process or scientific experience is used by a member. Hence, it is not a sharing of costs or

reimbursement of a part of the expenditure incurred for the research, as and when it is completed.

- The AAR observed that the payment for such R&D expenditure can only be treated as a consideration for the use of the process or formula developed. Therefore, it would be treated as royalty under the Explanation 2 to Section 9(1)(vi) of the Act and under the Article 12(3) of the tax treaty. Accordingly, the applicant is either the recipient of the consideration or the conduit through which the consideration is paid to the concerned party.
- The definition of royalty under the tax treaty provides the use of a secret formula or process and the use of information concerning industrial, commercial or scientific experience which does not differ significantly from the definition under the Act. Therefore, the amount paid by 'A' India to the applicant under the agreement would be treated as royalty under Article 12(3) of the tax treaty.

51. DCIT v. TVS Electronics Ltd [2012] 52 SOT 287 (Chen)

Taxability of Fees for Technical Services

The taxpayer had made payments to a Mauritius company for a market survey conducted by them for preparation of project report without withholding of tax under the Act. The AO held that the taxpayer was obliged to withhold tax under Section 195 of the Act on such payments since these payments are FTS which falls under the Explanation 2 to Section 9(1)(vii) of the Act. Accordingly, relying on the decision of Supreme Court in the case of Transmission Corporation of AP Ltd.⁷⁹ the AO held that the taxpayer had violated Section 195 of the Act and therefore, he made a disallowance under Section 40(a)(i) of the Act. The CIT(A) held that the taxpayer was not liable to withhold tax under Section 195 of the Act and deleted the disallowance made by the AO.

Tribunal's ruling

The work done by the Mauritius Company for the taxpayer was a technical service, therefore, the amount paid to them was to be treated as FTS. It was not a case that payments were made for any construction, assembly, mining or a project undertaken by the recipient which would fall under the head

⁷⁹ Transmission Corporation of AP Ltd v. CIT [1999] 239 ITR 587 (SC)

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'salaries'. Therefore, by virtue of Explanation 2 to Section 9(1)(vii) of the Act, the type of service received by the taxpayer from a foreign company was FTS. Therefore, the AO was justified in taking this view.

When technical services are not covered under the tax treaty, whether fees received for such services could be considered as business income in the hands of recipient has not been analysed by any of the lower authorities. Admittedly, the tax treaty did not provide for taxing any fees paid for technical services. Only for a reason that tax treaty is silent on a particular type of income, it could not be said that such income will automatically become business income of the recipient.

Accordingly, when the tax treaty is silent on a particular article, the provisions of the Act have to be considered and applied and this aspect has not been dealt with by the lower authorities. Therefore, the orders of lower authorities on payments made for market survey are set aside and remitted back to the AO for consideration afresh in accordance with law.

Taxability of amount received on Annual Maintenance Contracts

The taxpayer was engaged in manufacturing and sale of computer peripherals. During the year under consideration, the taxpayer entered into AMCs with various customers to which it had sold its products.

In view of such AMCs, the taxpayer was to provide maintenance support for a period of one year from the date of contract. The taxpayer had shown as income only that part of the revenue pertaining to the AMCs which falls within the relevant financial year. In other words, pro-rata revenue for the period falling outside the financial year was not offered as income.

The AO held that the income accrued to the taxpayer at the time of raising the invoice for the AMC and therefore, the taxpayer was bound to show the full amount as per AMC as its income. Accordingly, the AO made addition of INR 36.82 million for the unexpired value of AMCs. However, the CIT(A) deleted the addition made by the AO.

Tribunal's ruling

- There is no dispute that the income not offered by the taxpayer during the relevant financial year, pertained to unexpired period of AMC falling outside the end of such year and goes to the subsequent year.
- There is no dispute that the taxpayer had recognised its income on pro-rata basis for the duration of the AMC contracts in the relevant

year. The clients of the taxpayer could at any point cancel the contract and get a refund for the unexpired period. The income was accruing on a day-to-day basis based on the progress of time and it did not accrue on the day of entering into the contract.

- An obligation was on the taxpayer to refund the unexpired value of AMC, if the AMC was cancelled by its customers. Therefore, it cannot be said that whole of the income had accrued to the taxpayer at the point of time it entered into the AMC.
- The principle of matching concept of income and expenditure comes to the aid of the taxpayer in such a situation. Therefore, the taxpayer was justified in its claim that income relatable to the unexpired period of AMC could be considered only in the subsequent year and not in the relevant previous year.

52. Van Oord ACZ Marine Contractors BV v. ADIT [2012] 52 SOT 423 (Chen)

The taxpayer, a company registered in the Netherlands is engaged in the business of dredging, reclamation and other marine and port related activities. The taxpayer was awarded a dredging contract by Gujarat Adani Ltd. and the dredging was to be carried out at Port Mundra in India. Subsequently, the taxpayer assigned the said contract to its fully owned Indian subsidiary.

Based on an assignment agreement executed with the Indian subsidiary, the taxpayer undertook to provide coordinating and facilitating services to its Indian subsidiary in carrying out the dredging work. The taxpayer acted as an inter-face between its Indian subsidiary and other providers of facilities. The taxpayer brought the dredgers which were deployed for the services and also provided other logistic and coordinating support services to its subsidiary.

The taxpayer received payments from its Indian subsidiary towards mobilisation and demobilisation, freight and hire charges, etc. The taxpayer was of the view that the aforesaid payments were reimbursement of expenditure incurred in providing the various facilities to its subsidiary and therefore, not taxable. However, based on the assignment agreement and Cost Allocation Agreement (CAA) entered into between the taxpayer and its Indian subsidiary, the AO treated the above reimbursements as FTS. Hence, the AO proposed to levy tax as the taxpayer had filed its return with 'Nil' income. The additions proposed in the draft assessment order passed by the AO were confirmed by the DRP.

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Tribunal's ruling

Taxability of reimbursements as Fees for Technical Services

- The taxpayer has undertaken to provide all sorts of services to its Indian subsidiary, wherever necessary, to execute the dredging contract. Such services include not only arranging the dredgers from abroad, but also application of technical mind to select and choose appropriate parties to execute the work entrusted to its Indian subsidiary.
- The argument of the taxpayer that the payments were made by the Indian subsidiary only as reimbursement of expenditure cannot be accepted, since the facilities arranged and coordinated by the taxpayer to support the operations of its Indian subsidiary are not layman's activities.
- Even to choose the best dredger, it is necessary to have adequate technical know-how about the nature and place of work to be carried out by its Indian subsidiary. It is not possible to simply say that the taxpayer had only brought dredgers from outside India to the Indian port for dredging and kept back once the work is over.
- Apart from arguing that the payments were in the nature of reimbursement of expenditure, the taxpayer has not explained anything about the pricing of the services for which the so-called reimbursements were paid by the Indian subsidiary. There is nothing on record to show that the price negotiated between the taxpayer and the third parties and the amounts reflected in the invoices issued by the third parties are prices comparable to similar services provided by international parties.
- The taxpayer has not established that it had offered services to the subsidiary company on cost to cost basis at best reasonable and competent prices available at that point of time. Therefore, it is not proper to rule out an element of profit in the invoices raised by third parties themselves, even though what was paid by the subsidiary company to the taxpayer is the same amount as reflected in the invoices.
- As the taxpayer has not explained the pricing factor with reference to the services reflected in the invoices issued by the third parties, it is

not possible to say that the taxpayer had not rendered any service to its Indian subsidiary in India.

- It is clear from the order of the AO that the subsidiary company does not have the technical, organisational and managerial competence to carry out the contract work by itself. Therefore, the taxpayer itself had, to a great extent, execute the contract work for and on behalf of its subsidiary. Therefore, the payments were in the nature of FTS and the AO is justified in taxing the same.

Dependent Agent Permanent Establishment

- In view of the finding that the amount received by the taxpayer from its subsidiary is FTS, the Tribunal felt that this ground was almost academic.
- When the veil of assignment contract is pierced and the root of the case is seen, it is found that there is interlacing of activities and interlocking of funds between the taxpayer and its Indian subsidiary in executing the dredging contract. In such circumstances, the relationship of agency is there and the existence of PE is also there.

53. TUV Bayren (India) Limited v. DCIT and TUV Management Service GmbH v. DCIT –[2012] 53 SOT 56 (Mum)

The taxpayer is a company incorporated in a Germany and having a branch in India i.e. TUV Bayren (India) Ltd. The Indian branch is engaged in the business of audit and procedure of norms for ISO 9000 Certification wherein quality system auditor of the taxpayer visits the company which wants ISO 9000 certification. These auditors shall carry out a pre-assessment audit after which a certification audit is conducted. Consequently, a report is prepared which is checked and verified by the taxpayer in Germany. On receiving the reply from the taxpayer, whether the company is fit for quality system certification or not, the company is given ISO 9000 Certificate which is valid for a period of 3 years.

The taxpayer was of the view that ISO certification and audit services do not fall under Article 12 of the tax treaty. Hence, it is business income and is to be computed in view of the Article 7(1)² of the tax treaty since business was carried out through a PE. The AO held that the services rendered by the taxpayer were FTS under the tax treaty and therefore, as per Article 12(5) of the tax treaty, the income of the taxpayer has to be computed in view of

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Article 7(3) of the tax treaty. Accordingly, applying the provisions of Section 44D of the Act, the AO assessed the income applying the tax at the rate of 20 percent under Section 115A⁴ of the Act on the entire gross receipts. The CIT(A) upheld the order of the AO.

Tribunal's ruling

- On a perusal of the nature of services provided by the taxpayer in India, the Tribunal held that taxpayer's case does not fall within the meaning of 'royalties', as there is no right to use of any other items described therein. Further, the service is mostly in the nature of 'audit work' wherein the auditors of the taxpayer visit the sites of the client and evaluate the clients quality system as prescribed in International Standard for ISO 9001/2, ISO 14001, QS 9000 etc. Based on this audit work, a report is prepared which is sent to certification body to the taxpayer which provides a certificate for a certain period, after reviewing the report and several stages of audit work which has been carried out for this purpose.
- Technical services require expertise in technology and providing the client such technical expertise which was not transferred in the instant case. Managerial service is used in the context of running and management of the business of the client, whereas in this case, there is no management of client's business, but evaluation of standards as per international guidelines.
- Consultancy is to be understood as advisory services wherein necessary advice and consultation is given to its clients for the business purposes. In an audit work there may be some incidence of advice given at the time of evaluation but it cannot be termed as pure consultancy services since in the audit work the auditor has to only evaluate the quality system and environmental system.
- Based on the perusal of such services, it cannot be inferred that the taxpayer has been providing technical, managerial or consultancy services. On a perusal of the print of the website of the taxpayer, it is seen that the first kind of services mentioned therein relates purely to audit work of ISO certification. Besides this, there are host of other services mentioned, which upto some extent can be considered to be in the nature of consultancy services. However, whether the taxpayer has been carrying out other services as mentioned therein besides

audit for certification of ISO, is not borne out from the records. On the contrary in the IAF guidance note, the auditor will not give any prescriptive advice or consultancy as a part of an assessment.

- Accordingly, the entire nature of services and activities carried out by the taxpayer falls within the realm of 'professional services' and not within the meaning of 'FTS' as provided under Article 12(4) of the tax treaty and Section 9(1)(vii) of the Act.
- Once it is held that it is not FTS, neither Article 12(5) nor Article 7(3) of the tax treaty would be applicable and consequently, the income cannot be determined by applying the provision of Section 44D of the Act. Thus, the taxpayer's income is to be computed in view of the Article 7(1) of the tax treaty and resultantly as per Section 28 to 43 of the Act.

54. Pinstorm Technologies Pvt. Ltd. v. ITO [2012] 24 taxmann.com 345 (Mum)

The taxpayer is a company engaged in the business of digital advertising and internet marketing. It utilises the internet search engine such as Google, Yahoo, etc. to buy space in advertising on the internet on behalf of its clients. The search engine carries out its programme whereby the taxpayer books certain words called 'key words'. Whenever any person searches through the net for a specific 'key word', the advertisement of the taxpayer or its client is displayed. For example, if the 'key word' 'Hotels in Mumbai' is searched for, the advertisement of 'Taj Hotel' may be displayed among sponsor links on the search engine page.

During the year under consideration, the taxpayer had made a payment to Google Ireland Ltd. (Google Ireland) and claimed that as advertisement expenditure. While making the said payment, no tax was deducted at source by the taxpayer on the ground that the said amount constituted business profits of Google Ireland and since it did not have any PE in India, the amount paid was not chargeable to tax in India.

According to the AO, the services rendered by Google Ireland to the taxpayer were in the nature of technical services and hence the taxpayer was liable to deduct the tax at source from the payment made against the said services. Since no such tax was deducted at source by the taxpayer, the deduction claimed by the taxpayer on account of the advertisement expenditure was disallowed by the AO by invoking the provisions of Section 40(a)(i)¹ of the

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Act. The CIT(A) held that the payment made by the taxpayer to Google Ireland for the services rendered was in the nature of royalty chargeable to tax in India. Since there was failure on the part of the taxpayer to deduct tax at source, the CIT(A) confirmed the disallowance made by the AO.

Tribunal's ruling

- As the issue involved in the present case as well as all the material facts relevant thereto, were similar to the case of Yahoo India (P.) Ltd.⁸⁰, the decision rendered by the co-ordinate Bench of this Tribunal in the said case has been followed.
- The amount paid by the taxpayer to Google Ireland for the services rendered for uploading and display of banner advertisement on its portal was in the nature of business profit. No tax was deductible at source on such payment since the same was not chargeable to tax in India in absence of any PE of Google Ireland in India. Accordingly, the disallowance made by the AO was deleted.

55. M-1 Overseas Limited [2012] 252 CTR 8 (AAR)

The applicant is a company incorporated in the Cayman Islands, with its Indian Project Office situated in Mumbai, India. It is engaged in the business of providing services and facilities in connection with prospecting for, extraction and exploration of mineral oils. It has entered into a contract with Naptogaz India Private limited (Naptogaz) for the provision of Mud Laboratory, operating personnel (Mud-Engineers) and Mud Chemicals. Naptogaz has a right to carry out petroleum operations pursuant to a Production Sharing Contract. The services to be rendered by the applicant under its contract, generally described as Mud Engineering Services, are to be rendered in connection with exploration and extraction of mineral oil.

Issues before the AAR

- Issue 1 - Is the income derived by the applicant in India, as per the contract, covered under the provisions of Section 44BB of the Act and not liable to be independently taxed as FTS in terms of Section 9(1)(vii) of the Act?

⁸⁰ Yahoo India (P.) Ltd. v. CIT [2011] 46 SOT 105 (Mum)

- Issue 2 - Whether service tax charged and collected by the applicant from Naptogaz form part of gross receipts for purpose of Section 44BB of the Act?

AAR ruling

- The AAR has concluded that the services rendered are in connection with the extraction of mineral oil. The question is whether the services will fall under the exception in Explanation 2 to Section 9(1)(vii) of the Act, so as not to qualify as FTS. Doing Mud work cannot be understood as undertaking a mining project. The project is undertaken by Naptogaz and the applicant is providing only certain services to Naptogaz.
- The AAR has discussed the interplay between Explanation (2) to Section 9(1)(vii) and Section 44BB(1) of the Act read with its proviso, in two recent rulings in AAR No. 1119 of 2011 and AAR No. 954 of 2011. The reasoning and conclusion therein apply to this case as well.
- FTS in respect of a foreign company are liable to be computed in terms of Section 44D or Section 44DA or Section 115A of the Act. Section 44BB(1) of the Act contains a proviso taking out from within the purview of Section 44BB(1) of the Act, cases where the provisions of Sections 42, 44D, 44DA, Section 115A or Section 293A of the Act apply. Section 44DA was introduced with effect from 1 April 2011 by Finance Act, 2010, after the ruling of Geofizyka⁸¹.
- Reading Section 44BB(1) of the Act in the light of this proviso, it is clear that FTS received for rendering services in connection with prospecting for or extraction or production of mineral oils, cannot be brought under this Section if Section 44DA or Section 115A of the Act applies to it. Suffice it to say that in view of the proviso to Section 44BB(1) of the Act, the applicant is not entitled to be assessed under Section 44BB(1) of the Act.
- For the reasons stated, it has to be ruled on issue 1 that the income derived by the applicant in India in terms of contract with Naptogaz is not covered under Section 44BB of the Act and is liable to be independently taxed as FTS in terms of Section 9(1)(vii) of the Act.

⁸¹ Geofizyka Torun Sp.zo.o [2010] 320 ITR 268 (AAR)

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- In view of this, the ruling on issue 2 does not arise, although the AAR has ruled in Siem Offshore Inc and other cases that the service tax element collected by the applicant would form part of the gross receipts for the purpose of Section 44BB(1) of the Act.

56. C.A.T. Geodata GmbH [2012] 24 taxmann.com 37 (AAR)

The applicant is a company incorporated under the laws of Austria and claims to be a tax resident of Austria. It is engaged in the business of acquisition and processing of 2D/3D Seismic Data for companies engaged in the exploration and production of mineral oil in various countries. The applicant was awarded the work of acquisition and processing of 3D land seismic data in a block by a consortium of Indian Company. This consortium was awarded contract by Government of India (GoI) for exploration of block under the New Exploration Licensing Policy – VII (NELP-VII) and such award was governed by the Production Sharing Contract (PSC). The applicant entered into an agreement with Indian Company for the purpose of carrying out detailed design, plan and execute acquisition of 3D seismic data in the concerned area and provide related services in accordance with the terms of the contract.

In order to undertake above scope of work, the applicant sub-contracted the work to Hardson Oil Fields Services Private Limited by executing a Memorandum of Understanding. Indian Company while making payment to the applicant withheld taxes under Section 195 of the Act. The applicant sought advance ruling to determine the correctness of tax withholding made by the Indian Company.

AAR's ruling

- Proviso to Section 44BB(1) of the Act exclude certain income from the purview of section 44BB(1) of the Act which was enacted as a special provision for dealing with consideration received in connection with mining activities. Section 44DA of the Act, which specifically deals with FTS in respect of non-resident, has been included in that exclusion vide an amendment by Finance Act, 2010 with effect from 1 April 2011.
- The AAR observed that the Authority recognised the expansive nature of Section 44BB(1) in the ruling in Geofizyka, but there was no occasion to consider the scope of exception contained in Section 9(1)(vii) of the Act. The AAR further observed that Geofizyka and other

cases were rendered before the amendment to the proviso by the Finance Act, 2010 and hence post amendment in respect of FTS, the applicability of Section 44BB(1) of the Act has to be considered in context of such amendment.

- A person who has merely gathered seismic data for a contractor who has undertaken a mining or like project, cannot be said to have undertaken a mining project. Such person can at the best be said to render technical services or services 'in connection with' the mining activity undertaken by the original contractor. Accordingly, the consideration received by such person would be regarded as FTS within the definition in section 9(1)(vii) of the Act.
- On construction of Section 9(1)(vii) of the Act, in the context of Section 44BB(1) of the Act, the applicant who has merely contracted for rendering certain prospecting activities to Indian Company, cannot claim to be assessed under Section 44BB(1) of the Act.
- For the reasons stated, it is ruled that the revenues earned by the applicant in India in terms of the contract with the Indian Company are not taxable in accordance with Section 44BB of the Act and are taxable only as FTS in terms of section 9(1)(vii) of the Act.

57. Dishnet Wireless Limited [2012] 210 TAXMAN 644 (AAR)

The applicant, an Indian Company, is engaged in the business of providing telecommunication services. STC, a Saudi Arabian Company (STC) was a member of a consortium which had entered into a Construction and Maintenance Agreement (C&M Agreement) for laying a cable system, EIG, which would link the Indian subcontinent with the UK. Under the C&M Agreement each member was to be allotted a capacity allocation in respect of territorial and submarine portions of the EIG cable system. Further, the members could transfer the allocated capacity to other telecom entities on a private basis, subject to satisfaction of prescribed conditions.

STC invested US\$50 million to acquire a 7.1265 percent stake in EIG cable system. STC entered into a Capacity Transfer Agreement (CTA) with the applicant wherein it transferred the right to use 40 percent of its allotted capacity in the EIG cable system to the applicant for a consideration of US\$20 million. Under the CTA, the applicant was also required to pay annual operation and maintenance charges to STC.

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AAR ruling

Taxability of payments towards acquisition of cable capacity

- The AAR observed that there was no transfer of ownership rights to the applicant and the applicant was only given the right to participate in the use of the EIG cable system. It held that transfer of capacity to the applicant amounted to 'making available' to a non-EIG party the right to use the capacity, and accordingly the payments could not be held to have been made for acquiring a capital asset.
- The AAR held that in view of the clarificatory amendment in Section 9(1)(vi) of the Act, the payments made by the applicant was for a right to use a process and/ or a right to use a commercial or scientific equipment, and hence would be taxable in India as 'royalty' under the Act.
- The AAR observed that under paragraph 2 of Article 12 of the tax treaty, if the consideration is 'royalty' it would be taxable in the country of the payer according to the laws of the State of the payer. Accordingly, the AAR held that the payments would be taxable as 'royalty' in India in terms of para 2 of Article 12 of the tax treaty.

Taxability of payments towards annual operating and maintenance charges

- The AAR observed that the above charges were payable by the applicant to ensure the right to use without breakdown and to maintain the entire system.
- Accordingly, the AAR held that the payments towards operation and maintenance charges do not constitute 'fees for technical services' under the provisions of the Act, and could be treated as the share of costs of maintenance incurred for the right to use the system acquired by the applicant.

58. Infosys Technologies Ltd. [2012] 210 TAXMAN 295 (AAR)

The applicant, an Indian Company, is engaged in the business of development and export of computer software and related services. The applicant undertakes the work of software development and related services for its clients across the world. The work would be either onsite work or offshore work.

The applicant has clients in Australia. In the year 1999, it has set up a branch office in Australia. Since the applicant felt that it would be more profitable to have a local presence in Australia, the applicant acquired 100 percent equity of an Australian company, which was renamed as Infosys Technologies (Australia) Pty. Ltd. (Infosys Australia).

The applicant undertakes work in Australia and then sub-contracts a part of the work to its subsidiary, Infosys Australia. Infosys Australia performs the work wholly in Australia. Accordingly, the applicant makes payment to Infosys Australia for such work.

Issue before the AAR

Whether the payments made by the applicant to Infosys Australia as consideration for the sub-contract work, is chargeable to tax in India?

AAR's ruling

- As per the Agreement between the applicant and the Infosys Australia the applicant is giving directions to Infosys Australia about the performance of its work. Further, the fact that services are rendered in Australia cannot override the legal effect of the circumstances noticed. Accordingly, the AAR held that the income of Infosys Australia arises in India.
- It is true that Infosys Australia is a 100 percent subsidiary of Infosys India. They are independent entities in the eye of law. Unless, the applicant is a PE of Infosys Australia, the income in the hands of Infosys Australia, a non-resident, for the work done by it, cannot be taxed in India.
- The work in Australia is no doubt secured by the applicant and the income from it is its income. But, what the applicant pays to Infosys Australia for getting the work done in Australia can only be deemed as its expenditure. However, that does not make that payment taxable in the hands of Infosys Australia by the authorities under the Act.
- The applicant is issued directions to Infosys Australia about the fulfillment of its contractual obligations to a customer in Australia and getting those obligations performed through its Australian subsidiary. The applicant passes on the risk to the Australian subsidiary. It also gives the subsidiary appropriate directions. But, even then the obligation of the applicant to the customers in Australia will survive.

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Therefore, the applicant has not made available technical knowledge, experience, skill, etc. to Infosys Australia.

- Whatever may be the position under the Act, in terms of tax treaty, the fees for technical services paid is not chargeable to tax in India.

59. DIT v. Nokia Networks OY [2012] 253 CTR 417 (Del)

The taxpayer, a tax resident of Finland, supplied GSM equipment comprising both hardware and software to Indian telecom operators under independent buyer-seller agreements. The installation activities were undertaken by the wholly owned subsidiary of the taxpayer, Nokia India Private Limited (NIPL) under independent contracts with the Indian telecom operators.

The issue for consideration before the Delhi High Court was whether the consideration received by the taxpayer for the supply of hardware and software would be chargeable to tax in India under the Act and the India-Finland Tax Treaty.

Based on the facts of the case, the Delhi High Court, *inter alia*, observed and held as follows:

Whether payments for supply of equipment are taxable

- In a transaction relating to the sale of goods, the relevant factor would be as to where the property in the goods passes.
- Even in the case of one composite contract, offshore supply is to be segregated from installation.
- Relying on the decision of the Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd v. DIT* [2007] 288 ITR 408 (SC), the High Court concluded that where the property in goods passed to the buyer outside India (i.e. on the high seas), the equipment was manufactured outside India, and the sale had taken place outside India, the income from the supply of equipment would not be taxable in the hands of the taxpayer in India.

Whether payments for software constitute royalty

- The language of the tax treaty differs from the language in the amended section 9(1)(vi) of the Act.
- The Bombay High Court in the case of *CIT v. Siemens Aktiengesellschaft* [2009] 310 ITR 320 (Bom) has held that the amendments in the Act cannot be read into the treaty.

- In its earlier decision in the case of DIT v. Ericsson A.B. [2012] 343 ITR 370 (Delhi), which had a similar fact pattern as that of the taxpayer, it was held that a copyrighted article does not fall within the purview of 'royalty'.
- Accordingly, the payment for software was held to be not taxable as 'royalty' in India.

60. Zuari Agro Chemicals Limited v. CIT [2012] 211 TAXMAN 171 (Bom)

The manufacturing operations of the taxpayer had been stopped due to a waste heat boiler tube bursting. Therefore, the taxpayer sought technical assistance from Toyo Engineering Corporation Limited (Toyo). Pursuant to the taxpayer's request, Toyo sent three technicians to India to repair the machinery. Consequently, Toyo raised an invoice on the taxpayer, which claimed separate amounts in respect of the air tickets for its personnel and the 'technical advisory services' rendered by them. The invoice specified the number of days on which the technical advisory services were rendered by each of Toyo's technicians, the rate per day and the over-time charges. Pursuant to such invoices, the taxpayer paid the amounts to Toyo. Subsequently, the taxpayer filed a return of income as an agent of Toyo. Thereafter, the said return was revised by declaring 'Nil' income on the ground that the payments were not taxable under the tax treaty.

The AO held that payments made to Toyo constituted FTS under Section 9(1)(vii) of the Act and that the same could not be considered as income from business operations. Accordingly, the payments were taxable under the tax treaty. The AO, therefore, proceeded to assess Toyo's income in the hands of the taxpayer as agents. The CIT(A) and the Income-tax Appellate Tribunal [the Tribunal] upheld the order of the AO.

High Court's ruling

- In the present case, Toyo has carried out the technical work and has not merely provided technicians to carry out the work. Therefore, the fees paid were not merely for deputing technical experts, but for the technical services rendered by Toyo. The services were rendered through technical experts engaged by Toyo does not detract from the fact that Toyo rendered the technical services since the technical services had to be rendered, inter-alia, through technical experts.

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- 'Technical services' is a composite phrase involving several activities, including rendering advice and suggestions as well as undertaking the actual physical tasks. Rendering technical services may involve one or more or all such activities and each case must be considered on its facts to ascertain whether the real purpose was the rendition of technical services. However, technical services in most cases would be rendered only by the input of technical personnel. Without them, there would be no start to rendering technical services.
- Toyo did not merely provide the services of its personnel. It provided technical services required for undertaking the repairs to the taxpayer's damaged machinery. The record indicates that Toyo rendered a package of facilities required for repairing the taxpayer's machinery which required the involvement of the technicians.
- It is not the taxpayer's case that the technical experts were paid separately by the taxpayer. Thus, even if there was any substance in taxpayer's submission, it does not make any difference, for the services were not confined merely to providing technical personnel but of carrying out by Toyo, albeit through them, the required repairs.
- The definition provided under the Explanation 2 to Section 9(1)(vii) of the Act is merely clarificatory in nature. Where a composite agreement is entered into for undertaking technical works, it falls within the meaning of the expression 'technical services' and the inclusive definition, in that event, would be clarificatory.
- The composite agreements providing for the carrying out of technical works through the technical personnel of the contracting party fall within the ambit of the term 'technical services' in view of the decision of the Supreme Court in the case of Continental Construction Ltd⁸².
- Where technical services are rendered by an enterprise to another, the same falls within the ambit of the expression 'technical services' and constitute the rendering of technical services even though the same required technicians to be deputed for carrying out the work.
- As is evident from the No Objection Certificate, Toyo did not merely depute its technical personnel, they themselves rendered the technical services through the medium of the technicians. They charged the

⁸² Continental Construction Ltd. v. CIT 1999 Supp.(2) SCC 567

taxpayer not merely for supplying personnel, but for rendering technical services.

- Further the taxpayer did not enter into a separate agreement with the personnel in respect of the services rendered by them. The invoices also establish that the consideration was for the entire scope of the repairs and not merely for making available technical personnel.
- The above ruling in relation to Section 9(1)(vii) of the Act would apply equally to Article 12(4) of the new tax treaty and the definition (in the new tax treaty) insofar as it includes the provision of services of technical or other personnel is merely clarificatory.

61. DCIT v. J.Ray McDermott Eastern Hemisphere Limited [2012] 54 SOT 363 (Mum)

The taxpayer, a Mauritius based company, was engaged in the business of installation of offshore platforms, decks, pipelines, jackets and various other similar activities, for the purpose of mineral oil exploration. The taxpayer was engaged in executing certain installation contracts in Tapti and Panna offshore fields in the Indian continental shelf.

The taxpayer was of the view that as per the tax treaty, a building site or construction or assembly project, or supervisory activities in connection therewith, would be regarded as a PE only where such site, project or supervisory activities, in connection therewith, continued for a period of more than nine months. However, in the instant case it did not fulfill the criteria of 9 months and hence it does not have a PE in India.

The AO rejected the claim of the taxpayer and held that since the aggregate period for the contracts so executed by the taxpayer exceeded the period of nine months, the taxpayer had a PE in India. The CIT(A) held that the duration of work in India exceeded 9 months and therefore, the taxpayer has a PE in India. The Tribunal remanded the matter back to the file of the CIT(A) and asked the CIT(A) to decide the matter afresh on the question of duration of project.

The CIT(A), in the fresh proceedings held that the duration of work in India in respect of each contract did not exceed 9 months and hence the taxpayer did not have any PE in India. Further the action of the AO in taxing the income under Section 44BB of the Act was confirmed.

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Tribunal's ruling

- A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established and continues to exist until the work is completed or permanently abandoned. Further the date on which sail out of barge starts or is completed is essentially a date consequent to abandoning the work at site.
- The CIT(A) has recorded a categorical finding that no preparatory work was done by the taxpayer as the construction designs were provided by the third party through independent contracts. The tax department could not controvert the finding given by the CIT(A) in this regard. Thus as per the findings recorded by the CIT(A) in the fresh proceedings it becomes clear that the duration of the contracts is less than 9 months.
- Further no material has been produced by the tax department to show that there is any infirmity in the CIT(A)'s order in recording the starting or completion dates or the computation of duration in respect of such contracts. Since the duration of the contracts is less than nine months, the mandate of Article 5 of the tax treaty cannot be activated.
- Once it is found that the duration in respect of each contract is less than 9 months, it will not constitute PE in terms of Article 5 of the tax treaty. In the absence of any PE of the taxpayer in India, there cannot be any question of taxability of business profit as per Article 7 of the tax treaty.

62. ACIT v. TexTech International Private Limited [2012] 139 ITD 382 (Chen)

The taxpayer, an Indian company, engaged in the business of e-publishing. The taxpayer entered into three types of Agreement with its US based subsidiary, Tex Tech Inc. USA (Tex Tech Inc), i.e. marketing agreement, offshore development Agreement, overseas services agreement. During the year under consideration, the taxpayer filed a tax return wherein it claimed deduction of outsourcing cost paid to Tex Tech Inc on which tax was not deducted at source. According to the taxpayer, services provided by Tex Tech Inc were rendered outside India and it was not chargeable to tax in India. Therefore, withholding of tax was not required under Section 195 of the Act. The AO held that Tex Tech Inc was rendering technical services and

such services falls within the definition of Explanation 2 to Section 9(i)(vii) of the Act. However, since tax was not deducted on such payments, it would be disallowed under Section 40(a)(i) of the Act.

The CIT(A) held that payments made by the taxpayer did not fall within the definition of FTS under the tax treaty and therefore, withholding of tax was not required under Section 195 of the Act. Accordingly, the CIT(A) deleted the disallowance made by the AO.

Tribunal's ruling

- Services rendered by the Tex Tech Inc can fall under Article 12(4)(b) of the tax treaty if the entity abroad 'makes available' technical knowledge, skill, know-how or process to the taxpayer in India; or otherwise, the services rendered by entity abroad should consist of development and transfer of technical plan or technical design. As per the marketing agreement, no technical service was involved in marketing services because no technical knowledge or skill or experience was made available to the taxpayer.
- As per the overseas services agreement, Tex Tech Inc had to use its expertise, tools and infrastructure for receiving manuscripts for production of book using its own resource, including servicing the customers and effecting dispatches to customer locations. Since the whole of the work was done by Tex Tech Inc, it could not be said that taxpayer was receiving any technical knowledge, skill, know-how, etc, from Tex Tech Inc.
- On a perusal of the scope of Clause 3.1 and 3.3 of the Offshore Development Agreement it is clear that the services would involve technical know-how, but, there was no technical knowledge as such made available to the taxpayer which will give it an enduring benefit.
- Clause 3.2 of the Offshore Development Agreement specifies that the taxpayer had to use the instructions sent by Tex Tech Inc along with files, for carrying out digitisation services. If such instructions were in the nature of technical knowledge which imbibed in the taxpayer any technical expertise, which in turn helped it in its e-publication business, such that an enduring benefit was received by it, then such services would fall within the purview of Article 12(4)(b) of the tax treaty.

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- On a interpretation of term 'making available' given by the Karnataka High Court in the case of De Beers India Minerals Pvt. Ltd, it was clear that except for the work mentioned in Clause 3.2 of the Offshore Development Agreement, there was no technical knowledge or service made available to the taxpayer in any of the other work.
- Separate invoices were raised by Tex Tech Inc to the taxpayer, based on the three different agreements therefore, three agreements were not a composite one. The scope of work of these agreements shows that different types of services were rendered by Tex Tech Inc.
- With regard to the marketing agreement, and Overseas Services Agreement, no part thereof was having income element which was chargeable to tax in India in view of Article 12(4) of tax treaty. Therefore, the taxpayer was not liable to deduct tax on these payments.
- However, for offshore development agreement one of the services rendered could have an element of income chargeable to tax in India, which could make available technical services to the taxpayer in India. However, this aspect has not been examined by the lower authorities. Therefore, the issue of payments made by the taxpayer to its subsidiary abroad with regard to offshore development agreement is remitted back to the AO.

63. DDIT v. Euro RSCG Worldwide Inc [2012] 28 taxmann.com 176 (Mum)

The taxpayer was incorporated under the laws of USA and also was a resident of USA. The taxpayer acts as a communicating interface between multinational clients and various EURO entities. For some of the key multinational clients of the Euro Group, the taxpayer had set up a centralised group of persons who act principally as a communication channel between any local Euro entity and the client.

This team was typically serves as a common and centralised point of interaction for the clients. This ensures that the work produced is of an international standard that meets the client's expectations.

The taxpayer incurs cost as salaries, overheads, etc. in connection with the co-ordination services being rendered by team to various Euro entities. Since the local Euro entities benefit from the central co-ordination services, Euro

Worldwide Inc charges the local entity for such services. In addition, the taxpayer on a need basis provides business development and managerial assistance to the local Euro entities in the region.

During the year under consideration the taxpayer has provided certain assistance to Euro RSCG Advertising Private Limited (EARPL) [Indian Group company] and incurred certain costs on behalf of EARPL and received consideration of INR 7.56 million which was bifurcated as creative fees, database costs and client co-ordination fees.

The taxpayer filed nil return of income claiming that the payments received from ERAPL were taxable as business profit under Article 7 of the tax treaty and in absence of taxpayer's PE in India, the said receipts cannot be taxed in India. The AO held that consideration received was in the nature of royalty and taxable at the rate of 15 percent. The CIT(A) considered the nature of the services rendered and the fees paid and held that consideration from EARPL towards client co-ordination fees was in the nature of business profits. Since the taxpayer does not have a PE in India, the same was not taxable in India. With reference to the creative fees and the database cost, the CIT(A) was of the opinion that the same were in the nature of FIS and taxable at the rate of 10 percent under the tax treaty.

The taxpayer accepted the findings of the CIT(A). However, the tax department was aggrieved on the deletion of client co-ordination fee from taxing as royalty.

Tribunal's ruling

Co-ordination fees

- The Tribunal relied on the decision of CIT(A) where it was held that the taxpayer maintains communication channel between ERAPL and its clients. Therefore, the client coordination fees paid to the taxpayer cannot be termed as royalty because it was not a consideration for the use of right or to use any of the specified terms mentioned in the definition of royalty under Article 12 of the tax treaty.
- The observation of the AO that the client co-ordination services rendered by the taxpayer involve the use of a plan, secret formula, or process by ERAPL was without any basis. The client co-ordination fees can be taxed as business profits only. Since the taxpayer did not have a PE in India, the question of taxability of the impugned amount in India would not arise.

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Rate of tax

- As per the Article 12(2)(b) of the tax treaty the rate of 10 percent is applicable in the case of royalty referred to in Article 12(3)(b) and FIS as defined under this Article that are ancillary and subsidiary to the enjoyment of the property for which payment is received under Article 12(3)(b) of Article.
- Since the amounts were not royalty being considered either under Article 12(3)(a) or 12(3)(b), the rate of 10 percent on FIS was not correct. There was nothing on record that indicates that rate specified under Article 12(2)(b) of the tax treaty was applicable and not rate specified under Article 12(2)(a)(ii) of the tax treaty. Therefore, the creative fees and database cost were taxable at the rate of 15 percent.

64. Sandvik Australia Pty. Ltd v. DDIT [2013] 141 ITD 598 (Pune)

The taxpayer, a company incorporated in Australia, filed a return of income declaring nil income. During the year under consideration, it received payments from Sandvik Asia Ltd. and Walter Tools India Pvt. Ltd for rendering of IT support services. The nature of the services under the agreement between the taxpayer and Sandvik Asia Ltd., a Indian affiliate, includes giving advice to the receiving parties, help desk support, contacting Sandvik's IT personnel, providing IT operations and support services, infrastructure, disseminating related IT information, etc.

The taxpayer claimed that since the payment received did not make available technical knowledge, skill, knowhow or process, etc, it did not fall within the meaning of FTS under Article 12 of the tax treaty. Further, it did not have any PE in India and therefore, the payment was not taxable in India. The AO held that the services rendered by the taxpayer to its group companies were in the nature of FTS. Further, the AO held that the taxpayer cannot get the benefit of the tax treaty. The DRP confirmed the view taken by the AO.

Tribunal's ruling

- As per the agreement, the taxpayer was responsible for updation of patches of the software and provision of backup and recovery services in respect of data stored on the centralised server. The responsibility of the taxpayer was to maintain and upkeep of the centralised server owned by it.
- The taxpayer had not imparted any technical know-how, skill, process

or technical plan or design and hence, in view of Article 12(3)(g) of the tax treaty, the amount received by the taxpayer cannot be taxed in India.

- Though, the agreement was to be read as a whole and cannot be read into piece-meal basis but, nowhere it was suggested that the taxpayer has to make available the required technical know-how for solving the problems faced by the Sandvik Asia Ltd. in their IT related problems.
- The expression 'make available' is used in the context of supplying or transferring technical knowledge or technology to another. It is different than mere obligation of the person rendering the services of that persons own technical knowledge or technology in performance of the services.
- The terms of the agreement between the taxpayer and Sandvik Asia Ltd. did not support the case of the tax department that the taxpayer's case was covered under Article 12(3)(g) of the tax treaty as the taxpayer did not make available any technical knowledge or expertise to the recipient Indian company.
- The taxpayer had only provided the back-up services and IT support services for solving IT related problems to its Indian subsidiary. Hence, unless and until the services were not made available, the same cannot be taxable in India.
- Accordingly, it has been held that the services rendered by taxpayer to its Indian group companies, though are in the nature of technical services, but is not covered under Article 12(3)(g) of the tax treaty and hence, the same is not taxable in India.

65. Bajaj Holdings & Investments Ltd. v. ADIT [2013] 141 ITD 62 (Mum)

The taxpayer, engaged in the business of manufacturing of two and three wheelers, filed an application under Section 195 of the Act requesting the AO to issue a No Objection Certificate (NOC) for making payment to Xennia Technology Limited (Xennia), a UK based company, without any deduction of tax.

The taxpayer had entered into an agreement with Xennia for developing inkjet printers and four specific inks for the purpose of printing directly on two opposite sides of painted metallic petrol tank. The printer as per the

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specification of Bajaj Auto Ltd. (Bajaj) were to be developed at Xennia and thereafter, were to be shipped to India for commissioning at Bajaj plant in India. As per the agreement, Bajaj was required to make payment of 25,000 British Sterling Pound being start up fees for procuring inkjet printing solution.

The AO held that the technical design, drawing and plans were being made available by Xennia and therefore, the payment was in the nature of FTS which would be taxable at the rate of 15 percent under Article 13(2) of the India-UK tax treaty (tax treaty). The CIT(A) held that the payment would fall within the purview of royalty or FTS under Section 9(1)(vi) or 9(1)(vii) respectively of the Act as well as Article 13(4)(c) of the tax treaty.

Tribunal's ruling

- On a reference to the agreement, it was observed that the payment was not for a purchase of printer alone. The taxpayer had purchased a particular technology from the Xennia. Reference to the terms of the agreement, indicates that the Xennia had supplied the technology to the taxpayer. Not only the taxpayer was using it, it had right over the IP also. The agreement entered into by the taxpayer allowed it to file patent application, design application or any such application for IP rights arising out of the aforesaid IP.
- The transaction could not be considered as sale of printer only since it included the technology also. When a particular technology was made available exclusively to the taxpayer by Xennia, it could not be said that the agreement was only for sale of printer.
- As per Section 115A(1)(b)(BB) of the Act, tax on dividends, royalty and technical service fees in case of foreign companies has to be computed in a particular manner, if it is entered in to after a particular date. Neither the AO nor the CIT(A) had dealt with the issue. Therefore, the matter was restored to the file of the AO for deciding the question of applicability of lower rate of tax for the transaction.

66. Siemens Ltd. v. CIT [2013] 142 ITD 1 (Mum)

The taxpayer, Siemens Ltd., was required to make payments to Pehla Testing Laboratory (PTL) for carrying out type tests of the circuit breakers manufactured by it in order to establish that the design and the product meets the requirement of the International Standards. It was a standard

service provided by the Laboratory, which was done automatically by machines.

The circuit breakers samples sent to PTL underwent destructive tests in the lab and the same was not received back in India. Once it passed through the test, a certificate was given by PTL for the quality of the product manufactured by assessee. All this was done without human intervention and report was prepared for the test conducted.

In the application under Section 195(2) of the Act before the AO it was contended that payment made to PTL was not taxable in India as FTS since the payment was for a standard facility which was done automatically by machine without any human intervention. The AO and CIT(A) rejected the contentions of taxpayer on the ground that the services provided by PTL were highly technical in nature and held that the same was taxable as FTS as per India-Germany tax treaty as well as under Section 9(1)(vii) of the Act.

Tribunal's ruling

- Relying on the decision of the Delhi High Court in the case of Bharati Cellular Ltd.⁸³ and various other decisions it was held that the word 'technical' is preceded by the word 'managerial' and succeeded by the word 'consultancy'. Applying the principle of *noscitur a sociis* the meaning of the word or expression is to be gathered from the surrounding word i.e. from the context and hence it takes colour from the word 'managerial and consultancy' between which it is sandwiched. Managerial services and consultancy services has to be given by human only and not by any means or equipment. Therefore, the word 'technical' has to be construed in the same sense involving direct human involvement without that, technical services cannot be held to be made available. Where simply an equipment or sophisticated machine or standard facility is provided albeit developed or manufactured with the usage of technology such as user cannot be characterised as providing technical services.
- None of the lower authorities have either rebutted this contention of the taxpayer, or has given any adverse remark or findings that there was any human intervention in the process. The learned CIT(A) as well as AO have gone merely by the fact that such a type testing

⁸³ CIT v. Bharati Cellular Ltd. [2009] 319 ITR 258 (Del)

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services provided by the PTL is highly sophisticated and technical, and it cannot be considered as non technical.

- From the perusal of the flyer, it is seen that these tests are carried out in a Lab by the automatic machines though under observations of technical experts. Once these tests are done successfully by the machines, a certificate is issued by the authorities of the PTL.
- If any technology or machine developed by human and put to operation automatically, wherein it operates without any much of human interface or intervention, then usage of such technology cannot per se be held as rendering of 'technical services' by human skills. It is obvious that in such a situation some human involvement could be there but it is not a constant endeavour of the human in the process.
- Merely because certificates have been provided by the humans after a test is carried out in a Laboratory automatically by the machines, it cannot be held that services have been provided through the human skills.
- Since it has not been disputed that there is not much of the human involvement for carrying out the tests of circuit breakers and it is mostly done by machines and is a standard facility, the same does not fall within the ambit of Section 9(1)(vii) under the Act.
- Further the Supreme Court in the case of Bharti Cellular Ltd⁸⁴ has set aside the matter to the AO with regard to examination and to establish whether technical services provided, involved any kind of human intervention or not during the process of call communication. The Supreme Court has not reversed or adversely commented on the provisions or principles of law discussed by the Delhi High Court.

67. **Sintex Industries Ltd. v. ADIT [2013] 22 ITR 182 (Ahd)**

The taxpayer made payments to Texoplas Ltd. (the consultant), a UK based company, for providing details of fabric designs. The AO held that the services rendered by Texoplas Ltd. were covered by the definition of FTS as per the Explanation (2) to Section 9(1)(vii) of the Act. Further, it was also held that since the services rendered by Texoplas Ltd. were in the nature of consultancy and were used by a resident for the purpose of its business, the income shall be deemed to have accrued in India.

⁸⁴ CIT v. Bharati Cellular Ltd. [2011] 330 ITR 239 (SC)

Also, based on Article 13 of the tax treaty, the AO held that the experience and skills of the employees of Texoplas Ltd. was being made available to the taxpayer and therefore, services rendered were treated as consultancy services and the payment was FTS. The CIT(A) upheld the order of the AO.

Tribunal's ruling

- From the facts of the present case, it indicates that the consultant is required to transfer the fabric design to the taxpayer and those fabric designs were to be developed by the consultant. It was also required to provide detailed quantity progress report in writing to the taxpayer along with specific or new design developed by the consultant and therefore, the services rendered by the consultant to the taxpayer falls within the definition of FTS under Article 13(4)(c) of tax treaty.
- As per the MOU to India-USA tax treaty, there will be no FTS if technology is not made available to the person acquiring the services. It also specifies that the technology will be considered as 'made available' when the person acquiring the services is enabled to apply the technology.
- In the present case, fabric design is made available to the taxpayer and the taxpayer can apply such fabric design to process and produce garments and it can also sell and transfer such fabric design to outsider for consideration and there was no restriction on the taxpayer in this regard in the agreement.
- Considering all the facts and MOU to the India-USA tax treaty, the services received by the taxpayer and provided by the consultant were FTS and hence, tax is deductible from such payments. Accordingly, the payments made to the consultant for providing details of fabric designs are FTS and taxable in India.

68. Bangkok Glass Industry Co. Ltd. v. ACIT [2013] 215 Taxman 116 (Mad)

The taxpayer, a company incorporated in Thailand, entered into a technical know-how agreement with an Indian company for transfer of glass technology know-how to the Indian company and for providing technical assistance to the employees of the Indian company to operate the glass plant in India.

The AO held the consideration for the transfer of know-how and technical assistance to be taxable under Article 22 i.e. Other income Article of the

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India-Thailand tax treaty. The Tribunal however held the consideration for transfer of know-how to be in the nature of royalty and for technical assistance to be in the nature of other income under the India-Thailand tax treaty.

The issue for consideration before the Madras High Court, inter alia, was whether the consideration for technical assistance would be taxable in India in the hands of the taxpayer. Based on the facts of the case, the High Court, inter alia, observed and held as follows:

- The services rendered by the taxpayer cover transfer of know-how as well as giving technical assistance and therefore a part of the payment has to be classified as 'royalty' and the other part has to be assessed as 'technical services'.
- As the taxpayer did not have a PE in India, the consideration for technical services cannot be brought to tax under Article 7 of the India-Thailand tax treaty. The income which would be taxable in India in the instant case is only the income falling under Article 12 of the India-Thailand tax treaty as royalty income and nothing beyond that.
- Further, the consideration for technical assistance cannot even be taxed under the other income article of the India-Thailand tax treaty since it does not classify as miscellaneous income.

69. ITO v. Veeda Clinical Research Pvt Ltd [2013] 144 ITD 297 (Ahd)

During the year under consideration, the taxpayer had made certain payments to Veeda Clinical Research Ltd UK, for providing 'in-house training of IT staff and medical staff' and to Steve Matheson UK, for providing 'market awareness and development training'. Such training services were provided to the taxpayer's employees. The taxpayer claimed that it did not have any obligation to deduct tax at source under Section 195 of the Act since such training services did not 'make available' any technical knowledge, experience, skill, know how or process, or consist of the development and transfer of a technical plan or design as required under Article 13(4)(c) of India-UK tax treaty (the tax treaty).

The AO held that the expression 'make available' also include the cases in which technical services were made accessible to the recipient of services and not necessarily confined to the cases in which the recipient should be made expert in such technical knowledge etc. Accordingly, the AO treated

the training fees paid by the taxpayer as FTS taxable under Article 13(4)(b) of the tax treaty. The CIT(A) held that Article 13(4)(b) of the tax treaty deals with only technical and consultancy services which 'are ancillary and subsidiary to the enjoyment of the property' referred to in Article 13(3)(b) of the tax treaty, and it is unrelated to the facts of the present case. Hence, the payments were not taxable in India under the tax treaty.

Tribunal's ruling

- The law is now settled that as a condition precedent for invoking 'make available' clause in the definition of FTS, the services should enable the person acquiring the services to apply technology contained therein. Unless there is a transfer of technology involved in technical services extended by the UK based company, the 'make available' clause is not satisfied and therefore, the consideration for such services cannot be taxed under Article 13(4)(c) of the tax treaty.
- There can be situations in which technical training results in transfer of technology and consideration for rendering of such training services will be covered by the definition of FTS. However, what was really the decisive factor was not the fact of training services *per se* but the training services being of such a nature that results in transfer of technology.
- In the present case, the training services rendered by the service provider were general in nature as the training was described as 'in house training of IT staff and medical staff' and of 'market awareness and development training' and such training does not involve any transfer of technology.
- In order to invoke the 'make available' clause in the definition of FTS under the tax treaty, the onus is on the tax authorities to demonstrate that these services do involve transfer of technology. However, in the present case, that onus was not discharged by the AO, or by the tax department.
- The provisions of the Act apply only when it is more favourable to the taxpayer as compared to the provisions of the tax treaty. Therefore, when the case of the tax department fails on the tests of the tax treaty provisions, there was no occasion for their leaning upon the provisions of the Act.

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- Accordingly, the fees for training services were of general nature which does not seem to involve any transfer of technology and therefore, cannot be brought to tax under Article 13(4)(c) of the tax treaty.

70. Eruditus Education Private Limited [2013] 37 taxmann.com 337 (AAR)

The applicant, incorporated as a private limited company, collaborates with global business schools and foreign educational institutions in delivering executive education programmes in India. In pursuance of its objective, the applicant entered into a 'Programme Partnership Agreement' (the Agreement) with a foreign university to offer a management programme (Programme) to experienced, working Indian professionals. As per the Agreement, the foreign university is required to conduct teaching interventions while the applicant shall assist in the marketing, organising, managing and facilitating the conduct of the Programme. The Programme shall be for a period of 30 days spread over 11 months wherein teaching is conducted for 16 days in foreign campuses, 6 days in India and the balance 8 days through tele-presence.

The applicant shall compensate the foreign university for the cost involved in teaching the entire Programme and other incidental expenses which shall include costs of all learning materials, online tutorials etc. used by it in its teaching, use of facilities and lunches and coffee breaks for participants during the modules outside India, as well as travel cost of its faculty and staff. Upon successful completion of the Programme, the Indian participants will be awarded a certificate by the foreign university.

Issues before the AAR

- Whether the payments made by the applicant to the foreign university for the services under the Agreement is in the nature of FTS as per Article 12 of the tax treaty and/or under the provisions of Section 9(1)(vii) of the Act?
- Whether the foreign university would have a PE in India under Article 5(1) or 5(8) of the tax treaty in relation to the activity of conducting in-class teachings or through tele-presence in India?
- Based on the above; whether the payments received by the foreign university are chargeable to tax in India? Whether there are any withholding tax implications and if so, then at what rate?

AAR's ruling

- The services rendered by the foreign university to the applicant involve expertise in or possession of special skill or knowledge that is 'technical' in nature. Thus the payment for the services falls under the definition of FTS, both under the Act and the tax treaty. However, the case of the applicant will fall in the exclusion clause of Article 12(5)(c) of the tax treaty.
- There is no dispute regarding the fact that the foreign university is an educational institution and services rendered are in the nature of 'teaching'. Thus the payments are not considered as FTS under the tax treaty.
- Further the AAR held that the foreign university does not have a PE in India under Article 5(1) or 5(8) of the tax treaty in relation to the activity of conducting in-class teaching or through tele-presence in India. Thus the payments were not chargeable to tax in India and there will not be any withholding tax implications.

71. US Technology Resources Pvt. Ltd. v. ACIT [2013] 39 taxmann.com 23 (Coch)

The taxpayer is engaged in the business of providing software development services to the customers in India. The taxpayer entered into 'management service agreement' with the US company for obtaining management services. In terms of the agreement, the US company would provide assistance, advice and support to the taxpayer in management, decision making, sales and business development, financial decision making, legal matters and public relations activities, treasury service, risk management service and any other management support as may be mutually agreed between the parties.

During the year under consideration, the taxpayer made payment to the US company towards management services without deduction of tax. The AO held that the payment made by the taxpayer to the US company would be in the nature of consultancy fees and, therefore, the taxpayer was liable to deduct tax under Section 195 of the Act. Accordingly, the AO disallowed the payment on account of non-deduction of tax. The CIT(A) upheld the addition made by the AO.

Tribunal's ruling

- On reference to the tax treaty, it indicates that the term 'managerial service' did not find place in Article 12(4) of the tax treaty. However,

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on a perusal of MOU under the tax treaty, it indicates that if technical or consultancy services are made available technical knowledge, experience, skill, etc., then it would be considered as technical or consultancy services.

- It was observed that consultancy services which were not of technical in nature cannot fall under the 'included services'. However, as per MOU of the tax treaty, the consultancy services which are technical in nature are to be considered as technical and consultancy services under the tax treaty.
- The managerial advice rendered by the US company has been used in the decision making process of management, financial and risk management etc. Therefore, the knowledge which was accumulated through study, experience and experimentation with regard to management, finance, risk, etc. was nothing but a technical knowledge.
- The US company was giving training to the taxpayer's employees in making use of the inputs, experience, experimentation, assistance and advice rendered by them for taking a better decision in order to achieve the desired objectives. Therefore, the service rendered by the US company was in the nature of technical services and it cannot be said that advice received by the taxpayer is only a managerial advice and not technical advice.
- The decision is taken by the taxpayer on the basis of service provided by US company. Therefore, the technical knowledge, experience, skill possessed by the US company with regard to financial and risk management was made available in the form of advice or service which was used by the taxpayer in the decision making process not only in management but also in financial matters.
- Risk management service is a highly complicated one in the financial sector. Unless, the technical expertise and knowledge gained by the US company is made available to the taxpayer, they may not be able to analyse the situation to avoid risk in the business.
- The Tribunal observed that apart from providing advice, the US company is also providing training to the employees of the taxpayer. Therefore, the services of technical input, advice, expertise, etc. rendered by the US company are technical in nature.

- Therefore, the expertise and technology which was made available by the US company is technical service under Article 12(4)(b) of the tax treaty.

This case has been reversed by the Kerala High Court in the case of **US Technology Resources (P.) Ltd. (2018) 407 ITR 327 (Kerala)**.

72. Metro & Metro v. ACIT [2013] 39 taxmann.com 26 (Agra)

The taxpayer, a partnership firm, was a manufacturer and exporter of leather goods. The taxpayer was 100 percent export oriented unit. During the year under consideration the taxpayer made payments to a German company, in respect of leather testing charges. The taxpayer did not deduct taxes from these payments. The AO held that testing charges are technical cum consultancy services and it is deemed to accrue or arise in India under the Act. Accordingly, the same would be taxable in India under the Act as well as under the tax treaty. However, since the taxpayer did not deduct the taxes on the same, it would be disallowed under Section 40(a)(i) of the Act. The CIT(A) upheld the order of the AO.

Tribunal's ruling

Taxability of testing charges under the Act and the tax treaty

- Perusal of Article 12 of the tax treaty, it indicates that a source state has the rights to tax FTS, but the tax so levied, shall not exceed ten percent. Therefore, when a source state taxes the said income at ten percent rate or less, the said levy is in accordance with the scheme of allocation of taxing rights. However, when taxes levied exceed the specified rate, the extent to which such taxes exceed the specified rate, it will be contrary to the scheme of the allocation of taxing rights under the tax treaty and the taxability will be restricted in terms of the limited rights so allocated to the source state.
- There is a nexus between the taxability of services rendered to residents of a tax jurisdiction with that jurisdiction itself. The Tribunal held that the taxpayer itself contended that the intention of introducing the source rule was to bring to tax interest, royalty or FTS by way of creating a fiction in Section 9 of the Act, the source rule would mean that irrespective of the situs of services, the situs of taxpayer and the situs of utilisation of services will determine the tax jurisdiction.
- There has to be reasonable nexus and it is nobody's case that there is

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no nexus between income in the hands of a person providing technical services to India.

- Section 9(1)(vii)(b) of the Act has two distinct segments i.e. (i) in respect of services utilised in a business or profession carried on by Indian resident outside India, and (ii) in respect of services utilised in respect of earning any income from a source outside India.
- No doubt whether an India based business is 100 percent export oriented unit or not, it is still a business carried on in India, and it cannot be covered by the first limb of exception envisaged in Section 9(1)(vii)(b) of the Act.
- Even if entire products are sold outside India, the fact of such export sales by itself does not make business having been carried outside India. Once the business is set up and carried on in India, irrespective of where the end consumers are, the business is carried on outside India.
- The scope of second limb of this exception is rather narrow. In order to be covered by this exception, what is material is that, irrespective of where the business was situated, the services need to be used for earning income from any source outside India. A business outside India and a source outside India are used together in contrast, and can be viewed as reflecting relatively active and passive activities. The source of income, whether customers are inside India or outside India, continues to be business in India.
- The services were required because of the foreign importers and that aspect itself was not decisive and sufficient for the purpose of exclusion from the scope of Section 9(1)(vii) of the Act. The services should be for the purpose of earning an income from a source outside India. A customer is not the source of income, he is an important part of the business, which, in turn, is the source of income.
- Just because the user of services is a 100 percent export unit, it cannot be said that the technical services are used 'for the purpose of making or earning any income from any source outside India', and accordingly, outside the ambit of FTS under Section 9(1)(vii) of the Act.
- In view of above discussion, the payments made to a German company were taxable in India and, it cannot be said that the taxpayer

did not have obligation to withhold taxes from the remittances made to German company.

Disallowance under Section 40(a)(i) vis-à-vis 40(a)(ia) of the Act

- The scope of the words 'payable' in these two situations is materially different and the wordings detached from it may be, that the amount payable to a resident, in the context of Section 40(a)(ia) of the Act, reflects amount remaining payable. Provisions of Section 40(a)(ia) of the Act does not apply to Section 40(a)(i) of the Act and the taxpayer thus does not derive any advantage from the decisions in the context of Section 40(a)(i) of the Act.
- The provisions of Section 40(a)(i) of the Act cannot be interpreted in such a manner so as to restrict the scope of section to only amounts remaining payable at the end of the year. Such an interpretation will make the section redundant.
- In the case of Channel Guide⁸⁵, the Tribunal has observed that the amount paid to the foreign entity was not taxable in India in view of the legal position prevailed during the period of time and it cannot be disallowed under the Act. In the present case also the taxability arises on account of amendment made by the Finance Act, 2010 in Section 9(1) of the Act. Accordingly, following the decision of Channel Guide, the Tribunal held that the disallowance under Section 40(a)(i) of the Act cannot be invoked.

73. DIT v. Infrasoft Ltd. (ITA No. 1034/2009) [2013] 39 taxmann.com 88 (Del)

The taxpayer is an international software marketing and development company. It is engaged in the business of developing and manufacturing civil engineering software. The taxpayer had opened a branch office in India. The branch in India imports the package in the form of floppy disks or CDs depending on the requirements of their customers. The system was then delivered to a client/customer. The delivery of the system entails installation of the system on the computers of the customers and training of the customers for operation of the system. The branch office further undertakes the responsibility of updation and operational training apart from providing support for solving any software issues.

⁸⁵ Channel Guide India Ltd. v. ACIT [2012] 139 ITD 49 (Mum)

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During the year under consideration the customised softwares were licensed to the Indian customers and the branch office of the taxpayer in India performed services involving interface to peripheral installation and training. The AO taxed the receipts on grant of licence for the use of software as 'royalty' as per Article 12 of the tax treaty. Further CIT(A) held that the amount received by the taxpayer from its Indian customers under software licence agreement was in the nature of royalty and same was chargeable to tax in India as per Explanation 2 to Section 9(1)(vi) of the Act read with Article 12 of the tax treaty.

The Tribunal held that the amount received by the taxpayer under the licence agreement for allowing the use of the software was not royalty either under the Act or under the tax treaty. Aggrieved by this order the tax department filed an appeal before the High Court.

The High Court Ruling

- The High Court observed that as per the Licensing Agreement the license was non-exclusive, non-transferable and the software has to be used in accordance with the agreement. Only one copy of the software was being supplied for each site. The licensee was permitted to make only one copy of the software and associated support information and that also for backup purposes. It was also stipulated that the copy so made shall include Infrasoftware's copyright and other proprietary notices. All copies of the Software were the exclusive property of Infrasoftware.
- It was observed that a non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in Article 12 of the tax treaty. Where the purpose of the licence or the transaction was only to restrict use of the copyrighted product for internal business purpose, it would not be legally correct to state that the copyright itself or right to use copyright has been transferred to any extent.
- Distinction has to be made between the acquisition of a 'copyright right' and a 'copyrighted article'. Copyright is distinct from the material object, copyrighted. Copyright is an intangible incorporeal right in the nature of a privilege, quite independent of any material substance, such as a manuscript. Copyright or even right to use copyright is

distinguishable from sale consideration paid for 'copyrighted' article. This sale consideration is for purchase of goods and is not royalty.

- Further intellectual property, once it is put on to a media, whether it be in the form of books or canvas (In case of painting) or computer discs or cassettes, and marketed would become 'goods'. There is no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer.
- In view of above, the High court held that there was no transfer of any right in respect of copyright by the taxpayer and it was a case of mere transfer of a copyrighted article. The payment is for a copyrighted article and represents the purchase price of an article and cannot be considered as royalty.
- The High Court has not examined the effect of the retrospective amendment to Section 9 (1)(vi) of the Act and also whether the amount received for use of software would be royalty in terms thereof as the taxpayer was covered by the tax treaty, the provisions of which were more beneficial.

74. Verizon Communications Singapore Pte Ltd. v. ITO [2013] 39 taxmann.com 70 (Mad)

The taxpayer, a non-resident company, was engaged in the business of providing international connectivity services in the Asia Pacific region including India. The taxpayer provides International Private Lease Circuit (IPLC) that can transport voice data and video traffic. While the Indian leg of the connectivity service was provided by an Indian company (VSNL) using the gateway/ landing station belonging to it, the international leg of the connectivity service was provided by the taxpayer outside India, using its telecom service equipments situated outside India.

The AO held that the payments received by the taxpayer for providing IPLC to customers in India was taxable as a 'royalty' under the provisions of Section 9(1)(vi) of the Act and under Article 12(3) of India-Singapore tax treaty. The CIT(A) and the Tribunal also confirmed the AO's order.

Based on the facts of the case, the Madras High Court, *inter-alia*, observed and held as follows:

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- The payments received by the taxpayer are in the nature of a 'royalty' under the provisions of the Act and under the tax treaty;
- Even if the payment is not treated as one for the use of the equipment, it would be for use of the 'process' provided by the taxpayer;
- Explanation 5 to Section 9(1)(vi) of the Act clearly points out that the traditional concepts relating to control, possession, location on economic activities and geographic rules of source of income recede to the background and are not of any relevance in considering the question of royalty; and

The decisions in the cases of Asia Satellite Telecommunications Co. Ltd. v. DIT [2005] 332 ITR 340 (Del) (HC), Dell International Services India Pvt. Ltd. [2005] 305 ITR 37 (AAR) and Cable and Wireless Networks India (P) Ltd. [2009] 315 ITR 72 (AAR) are distinguishable as these decisions were rendered prior to the insertion of the aforesaid Explanation 5, which gives a very expansive meaning to the term 'royalty'.

75. IBM India Private Limited v. DDIT [I.T. (IT) A. Nos. 489 to 498/Bang/2013]

The taxpayer, an Indian company, was engaged in the business of providing information technology services and was a wholly owned subsidiary of IBM World Trade Corporation, USA. The taxpayer made certain payments to IBM Business Services, Philippines (IBM Philippines) for certain business information services, work force management, web content management and human resources accounting services rendered by them to the taxpayer.

The taxpayer contended that the tax treaty did not have an Article on FTS hence, such payments constituted 'business profit' under Article 7 of the tax treaty. Further, IBM Philippines did not have a PE in India hence, income of the IBM Philippines was not chargeable to tax in India. Accordingly, the taxpayer did not deduct tax at source (TDS) on such payments.

The AO held that since there is no Article in the tax treaty dealing with FTS, domestic law will govern the taxation of the sums paid by the taxpayer to IBM Philippines and therefore, the taxpayer is an 'assessee in default' for not deducting tax on such payments.

Tribunal's ruling

Nature of payments under the tax treaty

Payments to IBM Philippines, for providing services in the course of its business would be covered by Article 7 since the specific Article dealing with FTS is absent in the tax treaty. The services provided by IBM Philippines were in the course of its business and therefore, the payments received by it from the taxpayer partake the character of 'business profit' under Article 7 of the tax treaty.

Article 23 of the tax treaty deals with 'Other Income' and provides that items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of the tax treaty, shall be taxable only in that State. An item of income is said to have been dealt with other Articles of the tax treaty if such income can be classified as taxable or not under any of the Articles of the tax treaty.

In the present case, the payments are dealt with by Article 7 of the tax treaty and therefore, Article 23 has no application even though the business profits are not chargeable to tax in India in the absence of a PE of IBM Philippines in India. In support of this ruling, reliance was placed on various decisions².

Even if it is assumed that payments to IBM Philippines are not covered by Article 7 but are covered by Article 23 of the tax treaty dealing with 'Other Income', the payments would be chargeable only in Philippines since as per Article 23, items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of the tax treaty shall be taxable only in that State (i.e. Philippines in the present case).

Non-taxability of FTS under Article 24 of the tax treaty

Even though the tax treaty does not have an Article dealing with FTS, its taxation would be governed by Article 7 or Article 23 as the case may be. If Article 24(1) of the tax treaty is interpreted as dealing with taxation of items of income not dealt within the foregoing Articles 6 to 23 of the tax treaty, as per domestic laws, it would render Article 23 thereof redundant.

Article 24 does not provide any separate mechanism for quantification or computation of 'Philippine tax payable' or 'Indian tax payable' which is the starting point for claiming foreign tax credit. Accordingly, Article 24(1) operates in the field of computation of double taxed income and tax thereon in accordance with the domestic tax laws of each Contracting State, and is

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not a part of Article 6 to 23 which deals with the classification of income into different heads.

Under Article 24(4) and 24(5) of the tax treaty, 'Philippine tax payable' or 'Indian tax payable', includes inter-alia the tax which would have been payable but for an exemption or reduction of tax granted by the special incentive provisions which are designed to promote economic development of the country. Thus, in cases where the above exceptions apply, the computation of doubly taxed income and tax thereon would be made in accordance with Article 24(3)/ 24(5) of the tax treaty.

Article 24 of the tax treaty deals with the elimination of double taxation and therefore, it has no applicability regarding taxation of an item of income, FTS in this case, dealt with under the tax treaty.

Based on the above, the payments would not be chargeable to in India and consequently not liable for TDS under Section 195 of the Act.

76. Sumitomo Corporation v. DCIT [2014] 31 ITR(T) 310 (Del)

The taxpayer, a Japanese company, was engaged in supplying equipment to various companies in India. The taxpayer established an LO in India to act as a communication channel between the Head Office (HO) of the taxpayer and the Indian companies. The taxpayer had also established three Project Offices (PO), inter alia, for supply/ installation of equipment.

Under some contracts, the taxpayer was also responsible for supervising the installation of the equipment. The terms and condition of each of the contract was different and was not linked to each other.

The AO, inter alia, held that the supervision fees were effectively connected to the LO and therefore, were liable to be taxed as business profits under Article 7(3) of the India-Japan tax treaty. Further, the AO held that the aggregate period of supervisory activities in India for all the projects taken together was more than 180 days, and thus the taxpayer also had a supervisory PE.

The issue reached the Delhi High Court, which remanded it back again to the Tribunal to determine whether the supervision fees received from the Indian Company were taxable under Article 12(2) or under Article 12(5), read with Article 7(3) (as business profit) of the tax treaty.

Based on the facts of the case, the Tribunal, inter alia, held as follows:

- In order to apply Article 12(5) of the tax treaty, the beneficial owner of the FTS should carry on business in India, in which the fees arise through a PE and the contract in respect of which the fees are paid should be effectively connected with the PE in India. When these two conditions are satisfied, provisions of Article 7 of the tax treaty will apply.
- The LO was only facilitating the communication of the HO with the Indian company and was nowhere involved in the supervisory activities. Hence, the mere existence of the LO could not be a basis for the claim that the taxpayer had a PE in India.
- On the issue of the supervisory PE, the Tribunal held that where there are several projects where supervision work was done, the test of minimum period of 180 days should be determined for each project individually. In the instant case, since the period of supervision activities in India under each project was less than the minimum period of 180 days, the test of supervisory PE was not satisfied.
- The Tribunal held that income was taxable as FTS as per Article 12(2) of the tax treaty.

The case has been affirmed by Delhi HC (2017) 80 taxmann.com 247 (Delhi). Further, SLP has also been dismissed [2018] 96 taxmann.com 612 (SC).

77. ADIT v. Antwerp Diamond Bank NV [2014] 65 SOT 23 (Mum)

The taxpayer, a bank incorporated in Belgium, operating through branch in India. The HO of the taxpayer has acquired its main banking application software from an Indian software company. During the year under consideration, the taxpayer claimed HO expenditure attributable to its banking business operations in India. This expenditure was classified as general administrative expenditure of INR 9.01 million and data processing cost of INR 3.40 million.

The taxpayer claimed that the general administrative expenditure as well as data processing cost, paid to the HO, were in the nature of reimbursement of expenditure. However, the AO held that the taxpayer was providing services in the nature of commercial or scientific knowledge, to the Indian branch, which was in the nature of royalty and therefore, the taxpayer was required to

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deduct tax at source. However, since the taxpayer did not deduct tax, the payment would be disallowed under Section 40(a)(i) of the Act.

The CIT(A) held that the data processing cost paid by the taxpayer to the HO does not amount to 'royalty' and, hence, there was no liability to deduct tax. Consequently, the payment cannot be disallowed under Section 40(a)(i) of the Act. The CIT(A) held that the payment of INR 9.01 million are towards general and administrative expenditure, therefore the same will be allowed in accordance with the provisions of Section 44C of the Act.

Tribunal's ruling

Taxability of royalty

- Perusal of the agreement between the branch and HO indicates that only HO has the non-exclusive nontransferable rights to use the computer software and it does not have any right to assign, sub-license or otherwise transfer the license. Therefore, the payment by the branch for use of computer software was not the right in the copyright but only for doing the work from the said software which subsist in the copyright of the software.
- Perusal to the definition of royalty under Article 12(3)(a) of the tax treaty indicates that, when the payment of any kind is received as a consideration for the 'use' of or 'the right to use' of any of the copyright of any item or for various terms used in the said Article, then only it can be held to be for the purpose of 'royalty'. The said definition of 'royalty' is exhaustive and not inclusive and, therefore, it has to be given the meaning as contained in the Article itself and no other meaning should be looked upon.

The character of payment towards royalty depends upon the independent 'use' or the 'right to use' of the computer software, which is a kind of copyright. However, in the present case, the payment made by the branch is not for 'use' of or 'right to use' of software which is being exclusively done by the HO only. The branch sends the data to the HO for getting it processed and it was reimbursing the cost of processing of such data to the HO on pro-rata basis.

It is not the case of the tax department that the HO has provided any copyright of software or any copyrighted article developed by the HO for the exclusive use of the taxpayer for which the taxpayer is making

the payment along with the mark-up exclusively for the purpose of royalty.

If the payment for license of the software which is installed in the HO is being made by the HO, then any allocation of cost and reimbursement thereof by the branch to the HO cannot be termed as independent payment for the purpose of royalty.

- Accordingly, it has been held that the payment made by the branch to the HO towards reimbursement of cost of data processing cannot be held to be royalty under Article 12(3)(a) of the tax treaty. Consequently, there was no requirement to deduct tax on such payment and therefore, the disallowance under Section 40(a)(i) of the Act will not apply.

Clubbing of data processing expenditure along with the general administrative expenditure

- The data processing cost pertains to allocation of expenditure incurred by the HO on pro-rata basis for the banking application software acquired by the HO. Such expenditure does not fall within the meaning of 'Head Office Expenditure' as provided in Section 44C of the Act. The nature of expenditure as given in Section 44C of the Act has to be necessarily in the nature of executive and general administrative expenditure only.
- Accordingly, while relying on various decisions⁵, the Tribunal upheld the CIT(A)'s order where it was held that the data processing cost does not fall within the ambit of general administrative expenditure under Section 44C of the Act and such expenditure was allowed as business expenditure. Further the balance payment towards general and administrative expenditure, were allowed in accordance with the provisions of Section 44C of the Act.

78. Centrica India Offshore Pvt. Ltd. v. CIT [2014] 364 ITR 336 (Del)

The taxpayer, an Indian company, was established as a wholly owned subsidiary of a U.K. based company to overlook and manage certain back office functions outsourced to Indian vendors by two subsidiaries (one in U.K. and other in Canada) of the U.K. based parent (overseas entities).

To seek support during the initial years of the operations, the taxpayer sought some employees on secondment from the overseas entities. The

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seconded employees were to work under the supervision and control of the taxpayer. The taxpayer reimbursed the salary cost of the seconded employees to the overseas entities on a cost-to-cost basis and also withheld and paid tax in India on the salary paid to the seconded employees.

The taxpayer filed an application before the AAR, seeking a ruling on the issue of taxability of the sums reimbursed in the hands of the overseas entities and consequential withholding tax obligations on the taxpayer. The AAR ruled that the overseas entities constituted a Service PE in India under the tax treaty, and hence the taxpayer was obliged to withhold tax at source.

Aggrieved by the ruling given by the AAR, the taxpayer filed a writ petition before the High Court seeking to quash the ruling of the AAR.

The High Court ruled that the services rendered by the seconded employees qualified as 'technical services', inter alia, for the following reasons:

- The overseas entities have provided 'technical services' to the taxpayer, since, inter alia, the expression FTS/Fees for Included Services (FIS) in the tax treaty includes the provision of the service of personnel;
- The payment is not, in nature, a reimbursement, but rather a payment for rendering services. The nomenclature or less than expected charge for such services cannot change the nature of the service;
- The seconded employees possessed the necessary technical knowledge and skills which were 'made available' to the employees of the Indian company till the necessary skill set was acquired by the employees of the Indian company. Further, the High Court upheld the ruling of the AAR that the seconded employees create a service PE of the overseas companies. While reaching its conclusion the High Court noted, inter alia, the following:
 - There was no employment relationship between the taxpayer and the seconded employees since the assessee had no right to terminate the employment of the seconded employees;
 - The seconded employees could not sue the taxpayer for default in the payment of their salary;
 - The seconded employees retained their entitlement to participate in the retirement and social security plans of the overseas entities.

The Supreme Court dismissed the SLP against the High Court's order in **Centrica India Offshore (P.) Ltd. (2014) 227 Taxman 368 (SC)**.

79. Steria (India) Ltd. [2014] 364 ITR 381 (AAR)

An Indian company (the Company) entered into a Master services Agreement (the Agreement) with a non-resident partnership firm (the service provider) formed in France to receive various management services.

The company filed an application with the AAR seeking a ruling on the issue of taxability on the payments for the management services in the hands of the service provider, and the company's obligation to withhold tax at the source on such payments.

The company contended that the benefit of the 'make available' clause in the India-U.K. tax treaty, which was signed after 1 September 1989 should be available under the India-France tax treaty (the tax treaty) by virtue of the protocol signed between India and France. Thus in absence of the technical knowledge, experience, skill, know-how or processes being 'made available' by the service provider to the company, the services ought not qualify as FTS under the tax treaty.

The AAR ruled that payment for management services will be taxable as FTS as the benefit of 'make available' clause under the India-U.K. tax treaty cannot be imported to interpret the provisions of the tax treaty with France, inter alia, for the following reasons:

- A protocol cannot be treated in the same way as the provisions [Most Favoured Nation (MFN)] contained in the tax treaty itself, though it may be an integral part of the tax treaty;
- As per the protocol, the restrictions are on the rates and the benefit of 'make available' clause cannot be read into it;
- The Notification No. GSR 681(E), dated 7 September 1994 and Notification No. 11438 [SO 650(E), (F.No.501/16/80- FTD)], dated 10 July 2000 do not cover the 'make available' clause. Had the intention been to include the 'make available' clause in the India-France tax treaty, it should have been included in the notification.
- This case has been set aside by the Delhi High Court in the case of **Steria (India) Ltd. vs. CIT (2016) 386 ITR 390 (Delhi HC)** wherein the High Court has stated that in view of clause 7 of 'Protocol' forming part

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of India-France DTAA, less restrictive definition of expression 'fees for technical services' appearing in Indo-UK DTAA, must be read as forming part of India-France DTAA as well, hence payment by an Indian company to a French company for management services would not constitute Fees for Technical Services under India-French DTAA.

80. DDIT v. IATA BSP India [2014] 64 SOT 290 (Mum)

The taxpayer is a branch office of IATA, Canada. The said branch office is established with the permission of the Reserve Bank of India (RBI) for the purpose of undertaking certain commercial activities on no profit basis. In pursuance of an agreement entered into by IATA Canada through its administrative office in Switzerland, ADP-GSI, a French entity developed the system as per the specific need of the airlines and agents. The said system called BSP link, whereby the manual operations such as issue of debit notes/credit notes, issue of refund, billing statement, etc., relating to tickets are carried out electronically for agents as well as airlines who participate in the BSP Link.

These BSP Link services were provided to the agents and airlines operating in India, for which invoices were initially raised by ADP-GSI on Switzerland office of IATA, Canada who in turn raised the invoices on IATA, India. The payment against the said invoices thus was liable to be made by the taxpayer to Switzerland office of IATA, Canada.

An application under Section 195(2) of the Act was filed by the taxpayer before the AO seeking permission to remit the said amounts to Switzerland office of IATA, Canada without deduction of tax on the ground that the Switzerland office of IATA, Canada was not rendering any service to IATA, India and it was only collecting the funds from various IATA offices including IATA, India for making payments to ADP-GSI. The AO held that, the actual beneficiaries of DSP Link services were airlines and agents in India. The payment for the said services was in the nature of FTS chargeable to tax in India at 10 per cent as provided in Article 13 of the India-France tax treaty. Accordingly, the AO directed the taxpayer to deduct tax from the remittances made to Switzerland Office of IATA, Canada.

The CIT(A) held that the amount paid by the taxpayer to Switzerland office of IATA, Canada was not taxable in India as it was not in the nature of FIS under Article 12(4)(b) of India-USA tax treaty read with Article 13 of the India-France tax treaty and protocol thereto. Therefore, the taxpayer was not liable to deduct tax from the payment of the said amount.

Tribunal's ruling

- This restricted scope provided in the India-USA tax treaty and India-Portuguese tax treaty is applicable to the India-France tax treaty, as per clause 7 of the Protocol. As per the restricted scope of the tax treaty, the BSP link services provided by ADP-GSI France did not make available to the agents/air lines any technical knowledge, experience, skill, know-how, or processes so as to enable them to apply the technology.
- Perusal of the clauses of the agreement entered by IATA Canada with its administrative office in Switzerland, does not indicate that the services provided by ADP-GSI France made available to the agents/airlines any technical knowledge, experience, skill, know-how or processes so as to enable them to apply the said technology.
- The services envisaged in certain clauses of the agreement related to development services, testing and other facilities which were provided to the agents/airlines to enable them to operate and implement BSP link services in order to utilise the same for their own use.
- The decision of the Karnataka High Court in the case of De Beers India Minerals (P.) Ltd.² and the decision of the Kolkata Tribunal in the case of ITC Ltd.³ explaining the concept of 'technology being made available' fully support the view of the taxpayer.
- The decisions of AAR in the case of Cargo Community Network Pte Ltd.⁴, and ABC, In re⁵ are on different facts and the same cited by the tax department in support of the new plea that the payment being royalty, cannot be relied upon, as it was not even the case of the AO. Accordingly, the Tribunal upheld the order of the CIT(A) holding that the payment made for BSP link services rendered by ADP-GSI France is not in the nature of FIS chargeable to tax in India.

81. ITO v. Dholera Port Ltd. and Adani Port-Infrastructure Pvt. Ltd. [2014] 165 TTJ 684 (Ahd)

During the year under consideration, the taxpayer was contemplating to develop the Dholera Port, for which it had undertaken certain basic studies for evaluating the feasibility of the port. In order to evaluate the economic feasibility of the port, the taxpayer availed services of the U.K. based company to undertake morphological, sedimentation and navigation &

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mooring studies. In terms of the said services, the taxpayer made payment to the U.K. based company without deduction of tax. The taxpayer claimed that as per the Article 13 of the India- U.K. tax treaty, the said fees did not 'make available' technical knowledge, skill or know-how, etc., to the service recipient.

The AO held that the services provided by the U.K. based company were in the nature of consultancy services, which were made available to the taxpayer. The CIT(A) observed that since no technical knowledge, skill experience or process was made available to the taxpayer, and since the taxpayer was also not in a position to render such services on its own to others, the fees paid to the U.K. based company were not FTS under Article 13(4)(c) of the tax treaty.

Tribunal's ruling

- The reason for asking a report in respect of the Dholera Port was that as per the previous studies undertaken, it was noticed that there were strong tidal action and occasional cyclone activity at the site. The morphological activity at the site causes rapid coastal erosion and therefore, a survey was required to be undertaken to investigate all those aspects.
- The reports were in the form of preliminary assessment and therefore, the result of the survey was required to be projected in tabular and graphical form. Wherever it was appropriate, a design of the terminal with proper analysis was also required to be provided by the service provider. There was a clause of confidentiality and the know-how in the agreement.
- Perusal of the agreement indicated that the report prepared by the U.K. based company shall not be transferable by the taxpayer. The taxpayer shall not use the know-how in performing services for any other client in the future. Even the taxpayer was not entitled to sub-license any of the right granted in the report.
- In view of the various decisions⁸⁶, clauses of the tax treaty and

⁸⁶ Raymond Ltd v. DCIT [2003] 86 ITD 791 (Mum)

Diamond Services International v. UOI [2008] 304 ITR 201 (Bom)

Raymond Ltd v. DCIT [2003] 86 ITD 791 (Mum), NQA Quality System Register Ltd. v. DCIT [2005] 92 TTJ 946 (Del), CESC Ltd., v. DCIT [2003] 80 TTJ 806 (cal), Mckinsey

provisions of the Act, it was observed that there is a significant distinction between the definition of FTS provided under Section 9 of the Act as compared with the definition of FTS provided in Article 13 of the tax treaty.

- Accordingly, it was held that services rendered by the U.K. based company do not make available the technical knowledge, experience and know-how to the taxpayer. Therefore, the payment made by the taxpayer was outside the ambit of Section 195 of the Act.

82. Reuters Transaction Services Ltd. v. DDIT [2014] 151 ITD 510 (Mum)

Reuters Transaction Services Limited (Reuters U.K.) is incorporated under the laws of U.K. and is a tax resident of U.K. Reuters U.K. is engaged in the business of providing electronic deal matching systems enabling authorised dealers in foreign exchange, such as banks, etc. to effect deals in spot foreign exchange with other dealers.

Reuters U.K. had entered into a dealing services marketing agreement with Reuters India Private Limited (Reuters India) whereby Reuters India was to market the services of Reuters U.K. to the subscribers in India. The server of Reuters U.K. was located in Geneva. Reuters U.K. claimed that its revenue from the Indian subscribers is not liable to tax in India under the provisions of India-U.K. tax treaty as the same is not in the nature of royalty or FTS.

The AO concluded that the payments were in the nature of royalty as well as FTS. Alternatively, the AO also contended that Reuters India would constitute as a PE of Reuters U.K. in India.

Based on the facts of the case, the Mumbai Tribunal held as follows:

- By allowing use of software and computer systems to access the portal of Reuters U.K. for finding relevant information and matching the requests of Indian clients/subscribers amounts to imparting of information concerning technical, industrial, commercial or scientific

and Company v. ADIT [2006] 99 ITD 549 (Mum), Sheraton International v. DDIT [2007] 106 TTJ 620 (Del)

Mahindra & Mahindra v. DCIT [2010] 122 ITD 216 (Mum)(SB)

Intertek Testing Services Ltd., In re [2008] 307 ITR 418 (AAR)

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equipment. Effectively, the payments made by Indian clients/subscribers towards use and right to use of equipment and information for processing their request of foreign exchange dealings would constitute as royalty under Article 13 of the tax treaty.

- The Tribunal distinguished the ruling of the Delhi High Court in the case of Asia Satellite Telecommunication Company Limited [2011] 332 ITR 340 (Del) wherein the transponder capacity was used only for uplinking and downlinking of signals without any manipulations. However, in the current case, Reuters U.K. was providing media as well as necessary information and data equipment to the subscribers.
- With regard to the issue of PE under Article 5 of the tax treaty, the Tribunal observed that once the receipt has been characterised as Royalty then there is no requirement to go into the question of PE.

83. ITO v. Bennet Coleman & Co. Ltd. [2015] 152 ITD 331 (Mum)

The taxpayer is an Indian company engaged in the business of printing and publishing of newspapers. The taxpayer needed a sophisticated plant and machinery (mail room equipment) that could collate the various pages of the newspaper, which assisted in printing, picking and stacking them and pack the newspapers for timely delivery. To acquire such a plant and machinery, the taxpayer called for global bids for supply, delivery and installation of the plant and machinery and training of its staff. The bid was closed in favour of FERAG AG, a company registered in Switzerland.

The taxpayer entered into two contracts with FERAG AG, of which one was for the supply of the various components/units of the mail room equipment, and second was for installation and commissioning of the components/units of the mail room equipment in the premises of the taxpayer and training of the staff of the company for operation of this equipment to be supplied. In relation to the work done as mentioned in the second contract, the taxpayer made payment to FERAG, without deduction of tax at source.

The AO held that the payments made by the taxpayer, were liable to tax deduction at source as FTS in the hands of FERAG AG. Accordingly, the AO directed the taxpayer to pay the TDS with the interest thereon. The CIT(A) held that 75 per cent of the remittance was made by the taxpayer was towards installation and commissioning and therefore was not FTS as per Explanation 2 to Section 9(1)(vii) of the Act and therefore, not chargeable to tax in the hands of FERAG AG. However, the balance 25 per cent of the

remittance was towards training of the taxpayer's staff, was chargeable to tax as FTS.

Tribunal's ruling

The activity of installation and commissioning of the equipment is 'assembly' hence not taxable

- The mailroom equipment comprised of various units and was hence a complex equipment. The bid document stipulated that the units/components of the mailroom equipment would have to be installed and commissioned by trained and qualified personnel of the supplier, who shall, then provide training to the taxpayer's employees, on the operation and maintenance of mailroom equipment. The price quoted included installation, commissioning and training. The price for supply was separately indicated in the contract for supply and that for the services in the contract for services. The obligations under the contract for services were distinct.
- The contract for supply stipulated that the warranty can be claimed by the taxpayer only if the mailroom equipment were installed and put into operation by Vendor Certified Personnel. In other words, the person who installs the equipment should be certified by the vendor. This condition was not the same which required qualified personnel of the vendor to install the equipment which was indicated in the bid document and not in the contract signed by the taxpayer.
- Accordingly, the services rendered by FERAG AG, by way of installation, commissioning of the mailroom equipment and the training of the taxpayer's employees were not inextricably and essentially linked to the sale of the mailroom equipment.
- The services mentioned in the agreement for services indicated that the scope involved, was bringing and positioning various components, properly aligning them, connecting the individual units, etc. with a view to ensuring that all the components are working in unison, at maximum capacity and that the power consumed is as prescribed.
- FERAG AG, had, in fact, supplied a pickup station, a gripper conveyor, stacker and automatic bundle addressing system, etc. All these units and components had to be fitted together in a manner that they were properly positioned, aligned and, connected to ensure optimum

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functioning, in the shortest duration. This activity can be called as 'assembly'.

- The definition of the word 'assembly' does not appear in the Act and hence the word has to be interpreted as understood in common parlance. Consequently, the consideration paid to FERAG AG, related to installation and commissioning of the units/components of the mailroom equipment, will not fall within the purview of FTS as defined in Explanation 2 to Section 9(1)(vii) of the Act and therefore, not taxable.
- The consideration paid towards these services was only taxable in Switzerland in the hands of FERAG AG, by virtue of the provisions of Article 14 of the tax treaty.

The activity of training taxpayer's employees is not 'assembly' hence taxable

- The services rendered by FERAG AG, towards training the employees of the taxpayer cannot fall within the ambit of the expression 'assembly'. Article 14 of the tax treaty refers to 'residents of a contracting state' and hence it is not restricted to individuals as was the case in the India-Denmark tax treaty that came up for consideration before the Tribunal in the case of Christiani & Nielsen⁸⁷.
- Article 12(4) of the tax treaty defines FTS as including the services rendered by FERAG AG, towards installation and commissioning and training. Article 12(5) of the tax treaty provides that services covered under Article 14 of the tax treaty will not qualify for FTS.
- Article 14 of the tax treaty, while defining the term 'Professional Services', includes independent activities of engineers which does not cover training given to the employees of the taxpayer. Though a training activity that may be connected to an engineering concern, it would not constitute an engineering activity so as to fall within 'professional services' under Article 14 of the tax treaty.
- The training period would not have been substantial and that too not essentially shop floor training, as to how to operate the mail room equipment, which would have been training on the machine and

⁸⁷ Christiani & Nielsen Copenhagen v. ITO [1991] 39 ITD 355 (Bom)

therefore, Article 12 of the tax treaty shall apply on class room training. Accordingly, an estimate of 25 per cent of the training cost, as attributable to income from training would be reasonable.

84. Dr. Reddy's Research Foundation v. DCIT [2015] 68 SOT 47 (Hyd)

The taxpayer is a leading pharmaceutical research company carrying out research and development (R&D) activities in drug discovery. Such R&D activities are centered on new molecule discovery involving related biological process and chemical research. New molecular discovery research is focused on the therapeutic areas of metabolic disorders (insulin resistance and associated disorders in particular), cancer inflammation, bacterial infections etc. Thus, the taxpayer is mainly involved in drug discovery research.

Since the cost incurred on basic research is very high, and the time for exclusive marketing is less, the time factor is very crucial in drug discovery. Earlier a drug is introduced in the market, the better it is for the innovator company as it increases the 'time for exclusive marketing rights'. To increase this 'time' and also to reduce the cost of research, appropriate parts of research were allocated by the patent holding innovator company to other research organisations.

The taxpayer entered into an agreement with an UK company, Simbec Research Ltd. and a Netherlands Company, NDDO Oncology BV for conducting pre-clinical research studies. The taxpayer made the payments to M/s. Simbec Research Ltd. and NDDO Oncology BV (research organisations) during the Assessment Years (AY) 2002-03 and 2003-04.

The AO was of the opinion that the payments made by the taxpayer to the foreign parties could be considered as FTS. The AO considered that such payments were chargeable to tax in India as per the provisions of Section 5(2)(b) read with Section 9(1)(vii) of the Act. The AO also considered the provisions of the tax treaties and held that such payments were taxable as FTS.

Since, the taxpayer had made the payments without deduction of tax, because of its agreement with the foreign party, wherein, it had agreed to make the payment net of taxes, the taxpayer was liable for the consequences of violation of provisions of Section 195A of the Act.

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Tribunal's ruling

- The CIT(A) considered the case of Dr. Reddy Laboratories relied on by the taxpayer, and distinguished the same on facts to state that these are not agreements with contract research organisations but with independent research entities. The agreement also indicate that the taxpayer had rights over the patents, secret knowledge etc., attained during the course of conducting research.
- The taxpayer had admitted that the payments were taxable as FTS. Whereas, in the case of Dr. Reddy Laboratories the payments were not accepted as FTS, even under the Act.
- The CIT(A) rightly pointed out that India-USA and India-Canada tax treaties were entirely different from India-UK and India-Netherlands tax treaties.
- The Tribunal agreed with the CIT(A)'s order that the payments made were taxable as FTS. Since, the taxpayer had not deducted tax on the said payments, AO was correct in raising the demands under Section 201 and 201(1A) of the Act.

85. CIT v. Van Oord ACZ Equipment BV [2015] 373 ITR 133 (Mad)

The taxpayer is a company incorporated in Netherlands. The management and control of the taxpayer is situated in Netherlands. During the year under consideration, the taxpayer had let out dredging equipment to its Indian subsidiary company. The taxpayer claimed that the income earned from letting out of industrial equipment would not be taxable in India under the tax treaty. The AO held that consideration for use or right to use any industrial, commercial or scientific equipment falls within the definition of royalty under Section 9 of the Act and therefore, the same is liable to tax in India. The CIT(A) deleted the tax so imposed by the AO. Further, the Tribunal confirmed the order of the CIT(A).

High Court's ruling

- Payments for the use of equipments were covered under Article 12(1) of the old tax treaty⁸⁸. However, Article 12(1) of the tax treaty was modified with effect from 1 April 1991 and by virtue of this modification, the payment for the use of equipment has been excluded.

⁸⁸ Tax treaty signed on 21 January 1989

- Article 12(6) of the old tax treaty⁸⁹ defines the term equipment as payment of any kind received as a consideration for the use of or the right to use industrial, commercial or scientific equipment. However, as per the modified tax treaty under Article 12(6) of the tax treaty the definition for payments for the use of equipments has been excluded.
- Article 12(4)(b) of the tax treaty is modified with effect from 1 April 1991 and it included the payments for the use of, for the right to use industrial, commercial and scientific equipment within the category of 'royalties'. However, Article 12(4) was restored to original position with effect from 1 April 1998 which did not include equipment royalty clause.
- The above position would clearly indicate that for all practical purposes, the 'payments for the use of equipment' originally found in Article 12(1) as defined in Article 12(6) of the tax treaty was incorporated in the definition of the term 'royalties' in Article 12(4) of the tax treaty with effect from 1 April 1991, and subsequently deleted with effect from 1 April 1998 and thereby completely taken out from Article 12(1) and Article 12(2) of the tax treaty.
- This means that the payment for the use of equipment or any consideration for the use of, for the right to use industrial, commercial or scientific equipment was deleted and it was not taxable in the contracting state, in which they arise viz., in the given case India.
- As per the decision of the Azadi Bachao Andolan⁵ the provisions of the tax treaty would prevail over the provisions of the Act. Therefore, Section 9(1)(iva) of the Act was not applicable to the present case since the payments for the use of equipment was no longer taxable in India after the modification of tax treaty with effect from 1 April 1998.
- In the case of Poompuhar Shipping corporation Ltd⁹⁰, the tax treaties of Australia, USA, France, Germany, Norway, Singapore and Switzerland were considered and particularly, Article 12(3) which defined the term 'royalties' was under consideration. The said Article 12(3) of the tax treaty is *pari materia* with the Article 12(4) of the India-Netherlands tax treaty before the amendment with effect from 1 April 1998.

⁸⁹ Tax treaty signed on 21 January 1989

⁹⁰ Poompuhar Shipping corporation Ltd and another v. ITO [2014] 360 ITR 257 (Mad)

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- The decision in the case Poompuhar Shipping was distinguishable on facts of the present case since in the present case the amendment was made in Article 12(4) of the tax treaty with effect from 1 April 1998 by deleting the term 'payments for the use of the equipment' from the definition of 'royalties'. Further, in the decision of Poompuhar Shipping, it was a case of hiring the ship on time-charter basis, whereas in the present case, dredging equipment was leased out on bareboat basis, namely, without a master and crew.
- The tax department referring to Article 5(2) of the tax treaty contended that the taxpayer could be treated as having installation PE in India. However, plea of the tax department cannot be accepted as the dredging equipment was leased out on bareboat⁷. Therefore, it will not be treated as having a PE. Further, the entire control over the equipment was not with the foreign company, but with the Indian company.
- Accordingly, the amount received by the taxpayer for hiring out dredgers to an Indian company for use at Indian ports was not taxable in India.

86. Sandvik AB v. DDIT [2015] 67 SOT 297 (Pune)

The taxpayer is a Sweden based company. It does not have a PE in India. During the year¹ under consideration the taxpayer has received fees from its Indian subsidiary companies for providing commercial, management and production services. The taxpayer claimed that payment received from subsidiary companies are not taxable in India in view of the beneficial provisions of the India-Sweden tax treaty read with the Protocol. Accordingly, the fees received towards rendering the management services are not taxable as FTS under Article 12 of the India-Sweden tax treaty. The AO held that the payments received by the taxpayer from its subsidiaries are in the nature of the FTS under Section 9(1)(vii) of the Act as well as under Article 12 of India-Sweden tax treaty. The DRP confirmed the order of the AO.

Tribunal's ruling

- The India-Sweden tax treaty does not have a 'make available' clause within the definition of FTS. The India-Portuguese tax treaty contains the 'make available' clause. It uses the word FIS instead of FTS and as per Article 12(4) of the India-Portuguese tax treaty, payment for the consideration of technical or consultancy services will be treated as

FIS if such services 'make available' technical knowledge, skill, know-how or process, etc.

- Under the Protocol to the India-Sweden tax treaty there is an MFN clause. As per the MFN clause, if India signs a tax treaty with a third country which restricts the rate or scope of dividend, interest, royalty or FTS income, the same rate or scope shall also apply in case of the India-Sweden tax treaty.
- An MFN clause refers to a situation wherein two non-resident taxpayers are given impartial treatment by the concerned country. In tax treaties, the MFN clause finds place when countries are reluctant to forego their right to tax some elements of the income. An MFN clause can direct more favourable treatment available in other treaties only in regard to the same subject matter, the same category of matter or the same clause of the matter.
- The Protocol attached to the tax treaty takes care of a situation wherein either of the contracting states enter into a bilateral agreement in the nature of a tax treaty with another sovereign state and where the same subject matter has been given more favourable treatment by way of a definition or mode of tax, then the parties can claim the benefit on the recognised principle of the MFN clause.
- Klaus Vogel in his Third Edition on Double Taxation Convention has explained the role of the Protocol and its role in interpreting the treaty. The same has been considered by the Kolkata Tribunal in the case of ITC Ltd.³
- The Tribunal referred the AAR ruling in the case of Poonavala Aviations⁹¹ which has relied on the Double Taxation Convention (Third Edition), Klaus Vogel, who has clarified the role of a Protocol and its role in integrating a treaty. Legally, Protocol is a part of the tax treaty, and its binding force is equal to that of the principal treaty text. When applying a tax treaty, it is necessary to examine these additional documents. A Protocol is said to be a treaty by itself that amends or supports the existing treaty.
- In the present case, on the basis of the Protocol to the India-Sweden tax treaty, the taxpayer can claim the benefit of the conditions imposed for bringing to tax the FTS in the India-Portuguese tax treaty.

⁹¹ Poonawalla Aviation Pvt Ltd [2012] 343 ITR 202 (AAR)

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- Accordingly, it has been held that on the principle of the MFN clauses, the payment received by the taxpayer from its Indian subsidiaries cannot be brought to tax.

87. Bharti Airtel Limited v. ITO (TDS) [ITA No. 3593 of 2012] [2016] 67 taxmann.com 223 (Del)

The taxpayer is a global telecommunication company having operations in several countries including India. The taxpayer, as part of its international long distance (ILD) telecom services business, is responsible for providing services to its subscribers in respect of calls originated/terminated outside India. Thus, for providing ILD services, the taxpayer is required to obtain services of the FTO for the provision of carriage connectivity services over the last leg by the communication channel. The taxpayer entered into an agreement with an overseas network corporate to connect the call over the network. The taxpayer provides seamless end-to-end connectivity to the subscribers and the entire revenue from services is paid by the subscribers to the taxpayer. The taxpayer is in turn billed by the FTO in the form of IUC. The AO held that IUC paid by the taxpayer to the FTO, in the course of carrying out its business as an ILD service provider are in the nature of FTS under Section 9(1)(vii) of the Act, or in the alternative, in the nature of royalty under Section 9(1)(vi) of the Act. Accordingly, the income from IUC is deemed to accrue or arise in India in the case of an FTO. The AO levied a tax at a higher rate of 20 per cent on the gross amount of payment made to the FTO for all the years under consideration by applying the provisions of Section 206AA of the Act.

The Tribunal's ruling

Payment of IUC to FTO is not taxable as FTS

In the present case, there is no manual or human intervention during the process of transportation of calls between two networks and it is done automatically. Human intervention is required only for installation of the network and installation of other necessary equipments/infrastructure. Human intervention is also necessary for maintaining, repairing and monitoring each operator or individual network. Such human intervention cannot be said to be for inter-connection of a call. Human intervention in setting up enhanced capacity has no connection or relation with the traffic of call. Thus, in the process of actual calls, no manual intervention is required.

The inter-connection facility and the service of the FTO in picking-up, carrying and successful terminating the call over their respective network is a standard facility, and the FTO does not render any technical services to the taxpayer under interconnect agreement. Therefore, the payment cannot be considered as FTS in terms of Section 9(1)(vii) of the Act.

When FTS clause is missing in the tax treaty

When FTS clause is not available in the tax treaty, the income would be assessable as business income and it can be brought to tax in India, only if the FTO has a PE in India and the earning of income is attributable to activities or functions performed by such PE. This view is supported by various decisions⁹².

Payment of IUC to FTO is not taxable as royalty under the Act

The term 'process' used in the Explanation 2 to Section 9(1)(vi) of the Act in the definition of 'royalty' does not imply any 'process' which is publicly available. The words, which surround the word 'process' in clauses (i) to (iii) of Explanation 2 to Section 9(1)(vi) of the Act refer to various species of IPs such as patent, invention, model, design, formula, trade mark, etc. Thus, the word 'process' must also refer to a species of IP applying the rule of '*ejusdem generis*' or '*noscitur a sociis*' as held by the Supreme Court in the case of Bharti Cellular Ltd.

Based on the above and certain decisions⁹³, it was held that the term 'royalty' connotes exclusivity and the exclusive right in relation to the thing (be it physical or IP) for which royalty is paid should be with the grantor of that right. There is a clear distinction between a 'process' and the physical equipments and resources deployed in the execution of a 'process'. While the former is an intangible asset, the latter is tangible and has a physical existence.

The owner of the 'process' might grant the 'use' or 'right to sue' to different persons at the same time, but the exclusivity of the ownership should be with the grantor.

⁹² ACIT v. Paradigm Geophysical Pty. Ltd. [2010] 122 ITD 155 (Del), CIT v. Siemens Aktiengesellschaft [2009] 310 ITR 320 (Bom)

⁹³ CIT v. Neyveli Lignite Corporation Ltd. [2000] 243 ITR 0459 (Mad), N.V. Philips Gloeilampenfabrieken Eindhoven v. CIT [1988] 172 ITR 521 (Cal)

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If the IP is used by the owner himself and he bears the risk of exploitation or liabilities for the use, then as the owner makes own entrepreneurial use of the IP the income would fall under the scope of 'business income' and not 'royalty'. The 'royalty' in respect of the use of a 'process' would imply that the grantor of the right has an exclusive right over such 'process' and allows the 'use' thereof to the grantee in return for a 'royalty'. It is necessary that grantee must 'use' the 'process' on its own and bear the risk of exploitation.

The 'process' of running the network in the cases of all the telecom operators is essentially the same and they do not have any exclusive right over such 'process' so as to be in a position to charge a 'royalty'. For allowing the use of such process, the term 'use' in the context of royalty connotes use by the grantee and not by the grantor.

Explanation 6 to Section 9(1)(vi) of the Act, does not eliminate the requirement of successful exclusivity of the right in respect of such process being with the person claiming 'royalty' for granting its usage to a third party. None of the FTOs has any exclusive ownership or rights in respect of such process, and hence, the payment cannot be considered as royalty.

Explanation 5 to Section 9(1)(vi) of the Act applies only in case of royalty falling within the ambit of Explanation 2 of Section 9(1)(vi) of the Act. When a process is widely available in the public domain and is not exclusively owned by anyone, then it cannot constitute an item of IP for the purpose of charge of 'royalty' under clauses (i), (ii) and (iii) of Explanation 2 to Section 9(1)(vi) of the Act. Hence, Explanation 5 has no effect in the instant case.

Applying the decision of the jurisdictional High Court, it was held that the payment cannot be termed as royalty under Section 9(1)(vi) of the Act.

Payment of IUC to FTO is not taxable as royalty under the tax treaties

The definition of 'royalty' provided in the relevant tax treaties use the expression 'secret formula or process' and it is separated by a comma before and after the expression. This implies that 'formula/process' is a part of the same group and the adjective 'secret' governs both. Only payments received as consideration for the 'use of', or 'the right to use' is necessary for the payment to be termed as royalty. This is much narrower to the definition of 'royalty' under the Act.

Thus, under the treaties, in order to constitute royalty for use of or the right to use of a process, the process has to be 'secret'. In the case of the telecom industry, however, telecommunication services are rendered through standard facilities and no 'secret process' is involved.

There is no 'use of' or 'right to use' of any process in the present case and hence, even under the tax treaties, the payment cannot be termed as royalty. Based on various decisions⁹⁴, it was held that the payment was not 'royalty' under the tax treaties.

Position subsequent to the retrospective amendment by the Finance Act, 2012

There would not be any change in the above position, even subsequent to the retrospective amendments⁹⁵ introduced by way of Explanation 5 and 6 to Section 9(1)(vi) of the Act, since changes in the Act cannot be read into the tax treaties as long as there is no change in the tax treaties.

Following the jurisdictional High Court decisions⁹⁶ as well as decisions of other Courts, it was held that the amendments introduced by the Finance Act 2012 cannot be read into the tax treaties.

Whether the payment made by the taxpayer to the FTO is deemed to accrue or arise in India

The payments were neither received nor deemed to have been received by the FTOs in India. The payment does not accrue or arise to the FTOs, through or from any property of the FTOs in India or from any asset or source of income of the FTOs in India or through the transfer of any capital asset of the FTOs in India. The entire business operations of the FTOs have taken place outside India.

Under these circumstances and applying the decision in the case of Asia Satellite Communication Company Ltd., no income is deemed to accrue or arise to the FTOs in India.

⁹⁴ Asia Satellite Telecommunications Co. Ltd. v. DIT [2011] 332 ITR 340 (Del), DCIT v. PanAmSat International Systems Inc. [2006] 103 TTJ 861 (Del), Cable & Wireless Networks India (P) Ltd. [2009] 315 ITR 72 (AAR)

⁹⁵ Introduced by the Finance Act 2012 with effect from 1 June 1976

⁹⁶ DIT v. Nokia Networks [2013] 358 ITR 259 (Del), DIT v. New Skies Satellite BV & Ors. (ITA No. 473/2012)

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Alternatively, no part of such income can be said to be reasonably attributable to the business connection of the FTOs in India. Reliance is placed on the decision of Goodyear Tyre & Rubber Co.⁹⁷

Even under the tax treaties, the payments being in the nature of business income of the FTOs, Article 7 of the relevant tax treaties governs the same. The FTOs do not have any PE in India and therefore, the income cannot be brought to tax in India.

Beneficial rate provided under the tax treaty overrides the provisions of Section 206AA of the Act

The Tribunal observed that Section 206AA of the Act is prospective in nature. However, following various decisions⁹⁸, it was held that the beneficial rate provided in the tax treaty overrides the provisions of Section 206AA of the Act.

88. Rheinbraun Engineering Und Wasser GmbH v. DIT (ITA No. 2353/Mum/2006) – Taxsutra.com

The taxpayer company is registered in Germany and its core business activities include consulting services in the fields of exploration, mining and extraction. The taxpayer had offered the income received from Indian parties as FTS under Article 12 of the India-Germany tax treaty. The AO observed that the taxpayer entered into agreements with GIPCL, Neveyli Lignite Corporation Ltd. (NLC) and McNally Bharat Engg. Co. Ltd. (MNBECL) and received INR11.39 million from Indian parties under the above agreements. The AO held that the taxpayer had rendered various services including supervisory activities to GIPCL. The services were in the nature of installation or assembly projects. The taxpayer rendered supervisory services to NLC as well. The services rendered were connected with mining projects. As per the agreement entered into with MNBECL, the taxpayer had to render services for the finalisation of the design problem at hand. The taxpayer had a Permanent Establishment (PE) in India as per Article 5(2)(i) of the tax treaty. Accordingly, the AO held that the taxpayer should have paid tax at a higher rate.

⁹⁷ CIT v. Goodyear Tyre & Rubber Co. [1989] 184 ITR 369 (Del)

⁹⁸ DDIT (IT-II) v. Serum Institute of India Ltd. [2015] 56 taxmann.com 1 (Pune), Wipro Ltd. v. ITO (Int. Taxation) (ITA No. 1544 to 1547/Bang./2013)

The Mumbai Tribunal held that consultancy services in the fields of exploration, mining and extraction rendered by a German company did not constitute a PE in India under the tax treaty. A protocol to the tax treaty with respect to Article 7 states that income derived from a resident of a state from planning, project construction or research activities as well as income from technical services exercised in that state in connection with a PE situated in the other state, shall not be attributed to that PE. Accordingly, even if it is assumed that, the taxpayer had a PE in India; it will not be governed by Article 7 of the tax treaty. Such services are taxable as FTS under Article 12 of the tax treaty.

89. DDIT v. MSV International Inc [2016-TII-34-ITAT-DEL-INTL]

The taxpayer is a foreign company incorporated in the U.S.A. and engaged in the business of providing consultancy services in the areas of highways, transportation, water supply, waste management, etc. The taxpayer has set-up several projects offices in India to carry on its activities in India. During the AY 2006-07, the taxpayer had entered into contracts with various parties, mainly state governments, to provide them consultancy services as required under such agreements. The taxpayer disclosed consultancy charges of INR33.76 million after deducting expenses of INR28.88 million. The taxpayer showed profit before tax of INR4.88 million. The AO taxed consultancy charges at 20 per cent under Section 44D read with Section 115A of the Act. The CIT(A) after considering the provisions of Section 9(1)(vii) of the Act, Section 44D and Section 44DA inserted with effect from 1 April 2004, held that the gross receipts of the taxpayer were covered by the exclusion provided in the definition of FTS, and therefore, the same cannot be taxed as FTS.

Tribunal's ruling

It has been observed that to determine the nature of receipt, it is imperative to examine the scope of the work to be carried out by the taxpayer. In the present case, the taxpayer is engaged in the consultancy services, but that is the taxpayer's business in India. The AO has made an irrelevant analysis of disclosure in the return of income as well as the nomenclature described in TDS certificate when AO himself agrees that the taxpayer is engaged in the business of services with respect to highways, transport, etc. Therefore, it cannot be said that taxpayer is not carrying any business in India.

Any consideration which is for rendering of any managerial, technical or consultancy services is characterised as FTS. However, some exceptions

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are carved out where such managerial, technical or consultancy consideration is for any construction, etc. or like projects undertaken by the recipient. The AO has failed to consider these exceptions carved out in the definition of FTS. Therefore, the attempt made by the AO was on an incomplete reading of that Explanation ignoring exceptions. From the nature of work carried on by the taxpayer it was apparent that it had got the consultancy work related to laying down of roads, etc. which was for construction activity or a like project. Undisputedly the services rendered by the taxpayer were technical in nature but merely because the services were technical in nature they do not qualify as FTS in accordance with the provision of Explanation 2 to Section 9(1) (vii) of the Act. It was observed that the services provided by the taxpayer fall in the exceptions carved as construction activity and like projects.

On a perusal of the decision in the case of Agland Investment Services Inc.⁹⁹ it has been observed that the case of the taxpayer stands on stronger footings than the case relied upon by the tax department. On a perusal of Section 44D of the Act, it indicates that the FTS should have the same meaning as provided in Explanation 2 to Section 9(1)(vii) of the Act. Since receipt of the taxpayer is not FTS as defined in the above Explanation as it relates to construction activity, such receipt is out of the purview of presumptive taxability under Section 44D of the Act. It is also not controverted that taxpayer was carrying on similar activities in the preceding years as well, and the income earned from the said activities have been accepted by the tax department as business income and assessment made under Section 143(3) of the Act. Principle of consistency has been accepted by the Indian courts in many judicial precedents¹⁰⁰. Accordingly, it was held that consultancy charges were not taxable as FTS under the provisions of Section 44D read with Section 9(1)(vii) of the Act but were taxable under the provision of Act as business income.

90. DIT v. New Skies Satellite BV [2016] 68 taxmann.com 8 (Del)

Shin Satellite Public Co. Ltd. (taxpayer) is a company incorporated in

⁹⁹ Agland Investment Services Inc. v. ITO [1985] 22 TAXMAN 9 (Del)

¹⁰⁰ Radhasoami Satsang v. CIT [1992] 193 ITR 321 (SC), CIT v. Lagan Kala Upwan [2003] 259 ITR 489 (Del), Saurashtra Cement & Chemical Industries v. CIT [1980] 123 ITR 669 (Guj), CIT v. Paul Brothers [1995] 216 ITR 548 (Bom), CIT v. Modi Industries Limited [2010] 327 ITR 570 (Del)

Thailand, engaged in the business of providing digital broadcasting services as well as consultancy services to its customers who consist of both Indian residents and non-residents. The taxpayer provides these services through its satellite whose footprint covers a large geographical area, including India. New Skies Satellite B.V (taxpayer) is a company incorporated in Netherlands, engaged in providing digital broadcasting services. Both the taxpayers in the present case derive income from the 'lease of transponders' of their respective satellites. The taxpayers had filed nil returns for the relevant assessment years¹⁰¹. The AO held that the income was taxable under Section 9(1)(vi) of the Act as well as under Article 12 of the India-Thailand/India-Netherlands tax treaties. The Tribunal relied on the decision of the Delhi High Court in the case of Asia Satellite Telecommunication Company Ltd. where it was held that the receipts earned from providing data transmission services through the provision of space segment capacity on satellites do not constitute royalty within the meaning of Section 9(1)(vi) of the Act. Subsequently the Finance Act, 2012 amended the definition of royalty under Section 9(1)(vi) of the Act and inserted Explanation 4, 5, and 6. The inclusion of these explanations have attempted to undo the implications of decision in the case of Asia Satellite.

The issue before the Delhi High Court was whether the income derived by the taxpayers through data transmission services was taxable as royalty under Section 9(1)(vi) of the Act as well as Article 12 of the tax treaty. Whether the amended definition of royalty under the Act can be used to interpret the definition of royalty in the tax treaties.

High Court's ruling

Taxability under the Act

The legislature is competent to amend a provision that operates retrospectively or prospectively. Nonetheless, when disputes as to their applicability arise in court, it is the actual substance of the amendment that determines its ultimate operation and not the bare language in which such amendment is couched. The Delhi High Court in the case of TV Today Network Limited¹⁰² held in favour of the tax department, and observed that as far as domestic taxability of the income from data transmission services is

¹⁰¹ Shin Satellite – AY 2007-08 and 2009-10, New Skies – AY 2006-07 and 2008-09

¹⁰² DIT v. TV Today Network Ltd [2014] 221 Taxman 123 (Del)

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concerned, the Finance Act 2012 mandates it to be as such. Therefore, income from data transmission services is royalty.

Explanations 4 to 6 are designed as clarificatory amendments. Unarguably they have all the apparent characteristics of one. The words 'for the removal of doubts, it is hereby clarified...includes and has always included' qualify the interpretation in Explanation 5. In Explanation 6, the same words have been modified and they state 'includes and has always deemed to have always included'. This is the standard language used to communicate an intended retrospective effect. The circumstances in this case could very well go to show that the amendment was no more than an exercise in undoing an interpretation of the court which held income from data transmission services as non-taxable under Section 9(1)(vi) of the Act.

The High Court is disinclined to conclusively determine or record a finding as to whether the amendment to Section 9(1)(vi) of the Act is indeed merely clarificatory as the tax department suggests it is, or prospective, given what its nature may truly be. The issue of taxability of the income of the taxpayer in this case may be resolved without redressal of the above question purely because the taxpayer has not pressed this line of arguments before the court and instead stated that even if it were to be assumed that the contention of the tax department is correct, the ultimate taxability of this income shall rest on the interpretation of the terms of the tax treaties. The High court therefore proceeds with the assumption that the amendment is retrospective and the income is taxable under the Act.

Taxability under the tax treaty

No amendment to the Act, whether retrospective or prospective can be read in a manner so as to extend its operation to the terms of an international treaty. Clarificatory or declaratory amendment, which may seek to overcome an unwelcome judicial interpretation of law, cannot be allowed to have the same retroactive effect on an international instrument effected between two sovereign states prior to such amendment.

Article 39 of the Vienna Convention on the Law of Treaties, 1969 (VCLT) states the general rule regarding the amendment of treaties and provides that a treaty may be amended by an agreement between the parties. Unilateral amendments to treaties are therefore categorically prohibited. As held in the case of *Azadi Bachao Andolan*, treaties are creations of a different process subject to negotiations by sovereign nations. The Madras

High Court in the case of VR. S.R.M. Firms Ors held that 'tax treaties are considered to be a mini legislation containing in themselves all the relevant aspects or features which are at variance with the general taxation laws of the respective countries'. The Parliament is simply not equipped with the power to, through domestic law, change the terms of a treaty. A treaty is not drafted by the Parliament; it is an act of the executive.

The decision in the case of Asia Satellite takes note of the OECD Commentary and Klaus Vogel on tax treaties, to show that the process must in fact be secret and that specifically, income from data transmission services do not partake of the nature of royalty. India's change in position to the OECD Commentary cannot influence the interpretation of the words defining royalty as they stand today. The only manner in which such change in position can be relevant is if such change is incorporated into the tax treaty itself and not otherwise. Mere amendment to Section 9(1)(vi) of the Act cannot result in a change. It is imperative that such amendment is brought about in the tax treaty as well.

Since the Finance Act, 2012 will not affect Article 12 of the tax treaties, it would follow that the first determinative interpretation given to the word 'royalty' in Asia Satellite, when the definitions were in fact *pari materia* (in the absence of any contouring explanations), will continue to hold the field for the purpose of assessment years preceding the Finance Act, 2012 and in all cases which involve a tax treaty, unless the said tax treaties are amended jointly by both parties to incorporate income from data transmission services as partaking of the nature of royalty, or amend the definition in a manner so that such income automatically becomes royalty.

SLP has been granted against the High Court's order in the case of **DIT vs. New Skies Satellite B.V. (2016) 242 Taxman 3 (SC)**.

91. Cummins Limited (AAR No. 1152 of 2011) [2016] 381 ITR 44 (AAR)

The taxpayer, Cummins Limited, U.K. is a company incorporated in the U.K. Cummins Technologies India Limited (CTIL) is an Indian company engaged in the business of manufacture and sale of turbochargers. CTIL purchases turbocharger components directly from a third party in the U.K. and the U.S. and in relation to such purchases, the taxpayer, provides supply management services vide Material Suppliers Management Service Agreement (agreement).

In terms of the agreement, CTIL pays supply management service fees calculated at 5 per cent of the base price of the suppliers. The applicant does

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not have a Permanent Establishment (PE) in India in respect of the supply management services as per the provisions of the tax treaty. As per the agreement the applicant is responsible for the following:

- Finalisation of supplier prices from the U.K. and the U.S. suppliers and ensuring market-competitive pricing.
- Ensuring that the approved suppliers have the necessary manufacturing capacities and infrastructure to provide for the raw material requirements.
- Assisting in ensuring on-time delivery of components by the suppliers to Cummins India as well as the resolution of delivery performance issues with suppliers, if any.
- Ensuring that suppliers maintain strict compliance with the standards, procedures and processes and support in obtaining a response from a supplier to any quality control violation issue; and

Performance review of the supplier will be held by Cummins U.K. at least annually wherein it will perform regular product and process audits to check that the supplier process and controls meet the requirements.

AAR ruling

Taxability of FTS

On perusal of the agreement, it indicates that the CTIL is working with the applicant only to ensure market competitive pricing from the suppliers. The applicant maintains contract supply agreements with the suppliers after identifying the products availability, capacity to produce and competitive pricing. The applicant is not imparting its technical knowledge and expertise to the Indian company based on which the Indian company acquires such skill and will be able to make use of it in the future. Therefore, the 'make available' clause under the India-U.K. tax treaty is not satisfied. The AAR relied on the case of *De Beers India Limited*¹⁰³ by the Karnataka High Court.

The concept of 'make available' was analysed in the case of *Measurement Technologies Ltd.*¹⁰⁴ The AAR held that services in the nature of procurement can never be classified as technical or consulting in nature and are not

¹⁰³ CIT v. De Beers India Limited [2012] 346 ITR 467 (Kar)

¹⁰⁴ Measurement Technologies Ltd. (AAR No.966 of 2010)

making available any technical knowledge, experience, know-how, etc. It is also relevant to note that the services rendered in the present case are managerial in nature and managerial services were taken out of the ambit of FTS of the India-U.K. tax treaty with effect from 11 February 1994 and a clause relating to 'make available' was inserted. It indicates that the intention was to introduce such a clause and exclude managerial services. The AAR rulings relied on by the tax department are distinguishable on the facts of the present case.

Applicability of the anti-avoidance provisions

The objection of the tax department that the agreement entered into by the applicant with CTIL is a scheme for tax avoidance is without any merits. The tax department's contention that the applicant has entered into a contract with the Indian company with the main purpose to take advantage of the India-U.K. tax treaty is factually incorrect. On perusal of the facts stated by the applicant in the application, it indicates that the applicant maintains Global Cummins contract supply agreements with suppliers and is responsible for finalisation of supplier prices to Cummins Turbo Technologies worldwide, including CTIL, from the U.K. and the U.S. suppliers.

There is no mandate for CTIL to source the components from the approved suppliers only and if CTIL finds a better pricing from an alternate supplier, it shall be free to source the component from them. It is incorrect to say that such an arrangement has been done with the main purpose to avoid tax. Therefore, the objection of the tax department on this account is not correct.

Taxability of royalty

With reference to services being royalty and covered under Article 13(3) of the tax treaty, it is held that the nature of services related to identification of products and competitive pricing cannot qualify as royalties under the provisions of Article 13 of the tax treaty because it is not related to the use of, or the right to use any copyright, patent, trademark, design or modal, plan, secret formula or process, etc. Accordingly, it has been held that the supply management services fees received by the applicant are not in the nature of FTS or royalties under the India-U.K. tax treaty. In view of the fact that the applicant has no PE in India, the fees received are not taxable in India.

92. GVK Industries Ltd. v. Income-tax Officer [2015] 371 ITR 453 (SC)

The taxpayer, an Indian company entered into an agreement French company (Financial advisor) to seek services in preparation of a scheme for raising the finance and tie up for the required loan, for a power project in India. The services included, inter alia, financial structure and security package to be offered to the lender, providing an assessment of export credit agencies world-wide and obtaining commercial bank's most competitive terms, negotiations and documentation with lenders, structuring, negotiating and closing the financing for the project in a coordinated and expeditious manner. As consideration for these services, the NRC was to be paid a 'success fee'. The taxpayer approached the concerned Assessing Officer (AO), for issuing a 'No Objection Certificate' (NOC) to remit the said sum. However, the AO refused to issue the NOC. The taxpayer preferred a revision petition before the Commissioner of Income-tax (CIT), under Section 264 of the Act, where the CIT permitted the taxpayer to remit the said sum to the NRC by furnishing a bank guarantee for the amount of tax. Subsequently, the CIT revoked the earlier order passed under Section 264 of the Act, and directed the taxpayer to deduct tax and pay the same to the central government as a condition precedent for issuance of the NOC.

The taxpayer filed a writ petition before the High Court. The High Court held that the advice given to procure a loan to strengthen finances may come within 'technical' or 'consultancy' services. The 'Success fee' would thereby come within the scope of technical service under the ambit of Section 9(1)(vii)(b) of the Act. Accordingly, the taxpayer was not entitled to NOC.

The Supreme Court held that French company does not have a place of business in India. Since the taxpayer had not invoked the India-Switzerland tax treaty, the issue before the Supreme Court was whether the 'success fee' is FTS under Section 9(1)(vii) of the Act. Perusal of Section 9(1)(vii) of the Act lays down the principle which is basically known as the 'source rule', i.e. income of the recipient is to be charged or chargeable in the country where the source of payment is located, to clarify, where the payer is located. The clause further mandates and requires that the services should be utilised in India. As per the principle of nexus, the nexus of the right to tax is in the source rule. The source rule would apply where business activity is wholly or partly performed in a source state. As a logical corollary, the state concept would also justifiably include the country where the commercial need for the product originated, that is, for example, where the consultancy is utilised.

The expression, 'managerial, technical or consultancy service,' used under Section 9(1)(vii) of the Act, has not been defined in the Act and therefore, in the given factual matrix, the general and common usage of the said words has to be understood at common parlance. French company had the skill, acumen and knowledge in the specialised field i.e. to prepare a scheme for required finances and tie-up required loans for the project. The nature of services rendered by French company would come within the ambit of the term 'consultancy service'. Therefore, the tax at source should have been deducted on the amount paid as fees and could be taxable under the head 'FTS'.

93. Flag Telecom Group Limited v. DCIT [2015] 153 ITD 702 (Mum)

The taxpayer, a company incorporated in Bermuda, was set up to build a high capacity submarine fibre optic telecommunication link cable system i.e. undersea cable for providing telecommunication link. Such a telecommunication cable was known as 'Fibre Optic link around the Global Cable System' (Flag Cable System). The taxpayer had entered into a memorandum of understanding (MOU) with various parties which were mostly national telecommunication companies belonging to different nations, for the purpose of planning and implementing of the 'Submarine Fabric Optic Telecommunication Link Cable System' linking Western Europe (starting from the U.K.), Middle East, South Asia, South East Asia and Far East (ending in Japan). The taxpayer has been termed as 'founding party', whereas the other parties to the MOU have been termed as 'landing parties'.

Most part of the cable has been laid down on the sea bed and for the purpose of connection in the terrestrial land, the cable comes ashore in certain countries, connecting with the domestic telecommunication system, which has been termed as 'landing stations'. In India, Videsh Sanchar Nigam Limited (VSNL) was one of the original landing parties to the MOU in the cable system and part of the consortium to the Flag Cable System. For the purpose of selling the capacity in the cable system, the parties entered into a Cable Sales Agreement (CSA). On 31 March 1995, the CSA was entered into between the taxpayer and VSNL, which was further amended on 29 April 1998, by which time VSNL had bought the capacity in the said cable system.

The CSA provided for the ownership rights in the Flag Cable System with all the rights and obligations in the capacity were sold. VSNL can transfer, assign or sell the capacity. The entire procedure for ownership of capacity in

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the cable system and all other terms and conditions has been contained in a separate agreement titled as 'Construction and Maintenance Agreement' (C&MA). As per the terms, once C&MA comes into force, the CSA will come to an end. The C&MA was for a period of 25 years, which coincides with the life of the cable. The taxpayer received USD28.94 million from VSNL towards sale of capacity in the cable system. The taxpayer also received separate consideration for standby maintenance activities. The taxpayer claimed that the receipt was on account of sale of goods, from a non-resident to a resident which cannot be taxed in India. CSA and C&MA with VSNL have been executed by the taxpayer outside India on a principal to principal basis and the payment for the sale of capacity has also been made outside India. The Assessing Officer (AO) held that the payment was for 'right to use' the cable, hence, taxable as royalty in India under Section 9(i)(vi) of the Act. Further, the AO held that income from standby maintenance activities, which was separately received was taxable as FTS, because the maintenance requires highly skilled and technical personnel.

Tribunal's ruling

Sale of capacity in the cable system

Tax Management Foreign Income Portfolio US International Taxation of Telecom, for the treatment of tax in an undersea fibre optic cable system, clarified that the transfer of asset in the agreements must be somewhat metaphysically identified as an amount of digital capacity.

The cable has been identified in terms of its capacity to transmit, and not as an independent asset *de-hors* its capacity. This entire concept of 'capacity' used in the agreement by the parties to a telecom network cable has to be understood from the terms of the contract and not solely on a scientific term or technical angle. The main characteristic of the cable is transmission of capacity only for which rights or Indefeasible Right to Use (IRUs) are granted to the users of the telecom network.

As per clauses given in CSA and C&MA, VSNL had all the ownership rights and obligations in respect of the capacity purchased in the cable system. Further the management committee which included VSNL shall make all decisions on behalf of signatories to implement the purpose of the agreement. VSNL can transfer capacity to any other signatory or any other international telecommunication entity.

In case of termination of C&MA, the net asset of the entire cable system will be disposed off and any proceeds of cost will be distributed among

signatories in proportion to each signatory's shares. VSNL had all the risks and rewards of ownership which was unaffected by the taxpayer, inasmuch as VSNL not only had the exclusive domain on the rights to use but also right to resale or transfer its interest in the capacity in the cable system to the exclusion of the taxpayer.

The intention of the parties and their conduct can also be gauged by the accounting treatment given by the parties. The taxpayer recognised its revenue from sale of capacity on the date on which the risks and rewards of ownership have been transferred to the purchaser. The capacity has been treated as 'stock-in-trade' and the capacity which has been left or available in the balance sheet is a part of 'current asset' under the head 'capacity available for sale'. It has not been treated as a fixed asset. VSNL had also treated it as purchase of fixed assets and not as an item of expenditure.

The Tribunal agreed with the contention of the tax department that cable is only a medium, however, disagreed with the tax department's conclusion that capacity is not capable of sale. It is the capacity alone which is the subject matter of either 'agreement to sale', 'agreement for 'right to use' or 'indefeasible right to use', 'agreement for lease' or 'agreement for service', etc.

Either by looking at the form or looking through the substance, the only picture which emerges is that, parties intended to 'sell' and not to give or get 'right to use'. In the present case, in all the agreements the word 'capacity' has been defined in terms of saleable units which can be sold/purchased amongst the parties. The asset is to be identified as an amount of digital capacity in the cable, which is the subject matter of transfer. The capacity in a particular segment has an exclusive right qua the owner which can be used in the manner in which the owner proposes. There can be several owners of capacity in a particular length of the cable.

If VSNL had bought 51 Minimum Investment Units (MIUs) in the Flag cable system, which was running across in all the segments, it had not only the exclusive ownership of 51 MIUs, but also the exclusive right to use the said capacity in the manner in which it likes i.e. it could assign or transfer or sale to any other party. In case had there been only right to use to be given, then the ownership right to the exclusion of the taxpayer could not have been given to VSNL. Based on the apparent terms and conditions of the agreement between the parties, there was no assignment of 'right to use' but 'sale of capacity' in the cable system.

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Consideration is not royalty

The taxpayer right from the stage of entering the MOU with the parties, signing of capacity sales agreement and C&MA agreement, intended to sale the capacity with transfer of complete ownership, risks and rights. The entire agreement was for the period of 25 years which coincided with the life of the cable.

Accordingly, the signatory becomes the owner of the capacity in the cable system after the purchase, that is, VSNL in the instant case. This fact further establishes that there was no payment for simply the use of the capacity. In case of a 'royalty', agreement, the complete ownership is never transferred to the other party. The concept of transfer of ownership to the exclusion of the other party is denuded in the case of 'royalty'.

If the consideration has been received for transferring the ownership with all rights and obligations then such a consideration cannot be taxed under the head 'royalty'. Thus, the characterisation of the transfer, in the terms of the contract and agreement entered by the parties, is for sale and not for simple use. The payment received by the taxpayer from VSNL was on account of sales and hence constitutes business income and not royalty under Section 9(1)(vi) of the Act.

No business connection in India – business income not taxable

The taxpayer does not have any capital asset or property in India, which has been transferred to VSNL. The sale of capacity in the cable system does not arise through and from business connection in India, because sale has been made to VSNL which is unconnected to the taxpayer. The landing station is owned by the landing parties of the respective countries.

The taxpayer was not earning income through any aid or assistance of VSNL as VSNL was not carrying out any business for the taxpayer in India and therefore, in this case there was no income accruing or arising from business connection in India.

Neither the landing station nor the capacity in the cable is an asset of the taxpayer in India, hence there is no income accruing or arising through or from an asset of the taxpayer in India. Regarding source from India, the source of income must lie in India so as to be deemed to be income in India. The source must flow from an asset, whereas in this case there is no asset belonging to the taxpayer through or from which the taxpayer is having income.

No income had accrued or arisen in India within the deeming provision of Section 9(1)(i) of the Act, as the sale had concluded outside India on a principal to principal basis. The CBDT circular¹⁰⁵ would be squarely applicable in the case of the taxpayer for the relevant year. Further, as there is no deemed income accruing or arising to the taxpayer in India within the ambit of Section 9(1)(i), there is no attribution of income to operations in India. Consequently, the payment received by the taxpayer from sales of capacity made to VSNL was not taxable either as 'royalty' under Section 9(1)(vi) of the Act or 'business income' accruing or arising in India within the deeming provision of Section 9(1)(i) of the Act.

Taxability of standby maintenance charges and repair and maintenance charges

The entire cable system is to be operated and maintained by founding signatory in co-ordination with relevant landing party signatory. Flag Network Operation Centre (FNOC) has to provide overall network service surveillance and over all co-ordination of maintenance and repair operations of Flag cable system.

The taxpayer has to co-ordinate the deployment of the vessels for repairs and maintenance operation in accordance with the procedure defined. The maintenance activities undertaken by the taxpayer for the purpose of standby maintenance was for the arrangement for standby cover and maintenance and operation of FNOC. Standby maintenance charges were not in respect of any actual rendering of services but to maintain infrastructure for co-ordination and setting up conditions for efficient rendering of services in relation to maintenance and repairs of cable system.

There was a separate charge for repair and maintenance under the C&MA whereby, the taxpayer was actually required to undertake repair and maintenance. The standby maintenance was a fixed annual charge which was payable, not for providing services but for arranging standby maintenance arrangement which was required for a situation whenever some repair work in the undersea cable or terrestrial cable is actually performed.

In relation to the standby maintenance, the payment made by VSNL is not in the nature of 'managerial service' or 'consultancy services'.

¹⁰⁵ CBDT Circular No. 23, dated 23 July 1969 which has subsequently been withdrawn by a Circular No 7, dated 22 October 2009 and that the later Circular does not have a retrospective effect

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If the taxpayer was providing some kind of repair services in the cable system, then it can be termed as 'technical services'. However, if there was no actual rendering of services, but mere collection of annual charge to recover the cost of standby facility, agreed by all the members of the consortium on proportionate cost basis, then the taxpayer was not providing any kind of 'technical services'.

In the present case, the standby maintenance charges were in the form of fixed annual charge which was in the nature of reimbursement. Only actual cost incurred had been recovered from VSNL in providing the standby maintenance services. Accordingly, the receipts on account of standby maintenance charges cannot be taxed as FTS, under Section 9(1)(vii) as there was no rendering of services. However, whenever payment is received on account of actual repair or maintenance carried out, then same would definitely fall within the ambit of FTS chargeable to tax under Section 9(1)(vii) of the Act.

94. Qualcomm Incorporated v. ADIT [2015] 56 taxmann.com 179 (Del)

The taxpayer, a company incorporated in the USA, is engaged in the business of design, development, manufacture and marketing of digital wireless communication products and services, based on Code Division Multiple Access (CDMA) technology. The taxpayer had four principal business units i.e. QUALCOMM CDMA Technologies (QCT), QUALCOMM Technologies Licensing (QTL), QUALCOMM Wireless & Internet (QWI) and QUALCOMM Strategies Initiatives (QST). In the business model adopted by the taxpayer, the licensees typically pay a non-refundable license fee in one or more instalments and ongoing royalty based on the sale of products incorporating or using the licensed property. The AO issued a show cause notice as to why the royalty received by QTL, from non-resident Original Equipment Manufacturers (OEM) who were doing business in India by selling their products in India, should not be brought to tax in India. Subsequently, the AO held that the royalty paid by the OEMs to the taxpayer was taxable in India.

The Delhi Tribunal held when the royalty is for the use of technology in manufacturing, it is to be taxed at the situs of manufacturing the product. Further when the royalty is for use of technology in functioning of the product so manufactured, it is to be taxed at the situs of use. Taxation of royalty shall be in the jurisdiction where the technology is used.

The Tribunal held that while FTS are a consideration for the work done, royalty is a consideration for use of an asset: tangible or intangible. The connotations of the expression 'intellectual property' (IP) cover much more ground than 'software' simpliciter and essentially includes use of any patent or patented technology which is embedded in a CDMA handset. Technology for mobile communication viz 'operating systems using CDMA technology' was invented by the taxpayer and the taxpayer owns vital patents in respect of the same. Accordingly, the royalty is for use of such patented technology while the point of its collection, as a measure of convenience and in consonance with the industry practice, is from the manufacturer when the patented product is put into use, by sale. It was necessary to examine whether the use of patent, for which the impugned payments have been made by the OEMs to the taxpayer, was on the manufacturing process of the handsets or in the use of the patented technology embedded in the CDMA handsets. As this aspect of the matter, is a highly technical aspect which may also need expert advice, the Tribunal remitted the matter to the file of the AO for recording necessary factual findings after obtaining technical reports on the same and after giving due opportunity of hearing to the taxpayer.

95. Metropolitan Media Company Ltd. v. ACIT (ITA Nos.1193 & 1194/Bang/2013)

The taxpayer is in the business of printing and publishing of newspapers. It had entered into an agreement with Bennett Coleman & Company Ltd. (BCCL), another media company for purchase and utilisation of advertisement space in a daily newspaper, 'Times of India (Kannada)' owned by BCCL. The advertisement space so acquired was claimed to have been used by the taxpayer to feature advertisements of its clients or the advertising agency. The purchase price of the advertisement space has been debited in the books of account of the taxpayer as expenditure. However, tax was not deducted on the payment to BCCL towards the purchase of advertisement space. The AO held that the payment made by the taxpayer for the purchase of advertisement space is covered under the provisions of Section 194C of the Act, and therefore the taxpayer was required to deduct tax at source. As the taxpayer did not deduct any tax, the AO disallowed the said expenditure by invoking the provisions of Section 40(a)(ia) of the Act. The CIT(A) upheld the findings of the AO.

Tribunal's ruling

The scope and the meaning of work are explained in detail in the decisions and Circulars¹⁰⁶ relied on by the taxpayer. In terms of clause (iv)¹⁰⁷ of Explanation to Section 194C of the Act, advertising is also an activity which falls within the ambit of 'Work'. The work which media does for a client is for a certain consideration. In the present case, the media is BCCL which does the advertisement for the taxpayer or its clients. Therefore, there was no merit in the taxpayer's contention that BCCL is not doing any 'Work' for the taxpayer.

The payments made for booking of the advertisement space was essentially for advertisement purposes and not for the space as such. The client does not pay to take ownership of the space but for advertisement of his product/service. At the time of booking the advertisement space, BCCL was not concerned about whom the advertisement was intended for. Its only requirement was that the advertisement should comply with the laws in force at that time. Therefore, the payment made by the taxpayer to BCCL is for advertisement, which is covered under the provisions of Section 194C of the Act.

The taxpayer relied on CBDT Circular No.714, dated 3 August 1995 to contend that the transaction would not fall under 'advertising' within the meaning of Section 194C of the Act. However, Section 194C of the Act provides that tax is required to be deducted against payments made to contractors/sub-contractors, for carrying on any work, and under Section 194C the word 'work' would include advertising work also. In the present case, various terms of the agreement between the taxpayer and BCCL

¹⁰⁶ Sands Advertising Communication (P) Ltd v. DCIT [2010] 37 SOT 179 (Bang), CBDT Circular No.714, dated 3 August 1995

CBDT Circular No.715, dated 8 August 1995

¹⁰⁷ For the purpose of Section 194C of the Act "work" shall include –

- (a) Advertising;
- (b)
- (c)
- (d)
- (e)

But does not include manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from a person, other than such customer.

indicate that the taxpayer has not entered into the agreement in the capacity of an advertising agency. The taxpayer purchased bulk advertisement on principal-to-principal basis. After purchasing the same, the taxpayer is at liberty to sell the space to anyone and BCCL has no role or part in that regard.

The taxpayer had purchased the advertisement space for itself and not on behalf of any specific clients in the capacity of an advertising agency. Therefore, it was clear from the agreement that at the time of purchasing the bulk advertisement space, the taxpayer was merely a client to the media, BCCL in this case. The taxpayer is not a routing agency. It makes outright purchase of advertising space and exercises exclusive control over the space. It had the right to sell the space or retain it with itself. Further, this was not a case of payment made by an advertising agency to the print media. There was a transfer of advertisement space from BCCL to the taxpayer, who in turn sells it to other parties.

It can be inferred from the CBDT Circular No.715 of 1995 that the taxpayer was liable to deduct tax at source. Further, the decision relied on by the taxpayer in the case of Sands Advertising Communications (P) Ltd. is distinguishable on the facts of the present case. Accordingly, the payment made by the taxpayer to BCCL was towards advertisement and the taxpayer was liable to deduct tax at source under Section 194C of the Act. In view of the taxpayer's failure to deduct tax at source as required, the payments would be disallowed under the provisions of Section 40(a)(ia) of the Act.

96. Flag Telecom Group Limited v. DDIT [2015] 69 SOT 679 (Mum)

The taxpayer is a company incorporated in Bermuda. The taxpayer had built a submarine fiber optic telecommunication cable to link telecom traffic amongst Western Europe, Middle East, South Asia, South East Asia and the Far East. The capacity in the said cable system had been sold to various landing parties, which are mostly national telecommunication companies belonging to different nations. In India, Videsh Sanchar Nigam Limited (VSNL) was one of the original landing parties in the FLAG cable system. For the purpose of selling the capacity in the cable system to various landing parties, including VSNL, a Capacity Sales Agreement (CSA) was entered into amongst Landing Parties.

During the year under consideration, the taxpayer had received the payment from VSNL on account of the provision of standby maintenance activities, as

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provided in the earlier years. Further during the year under consideration the taxpayer had entered into an arrangement with certain telecom cable operators to provide restoration of traffic to their customers in the event of a disruption in the traffic on their cable system. Under these arrangements, if there is a disruption in the traffic on a particular segment of the cable operator, the taxpayer provides the alternative telecommunication link route through its own capacity in the cable.

The AO held that receipts from standby maintenance services and restoration services were technical in nature and therefore such services were taxable as FTS under Section 9(1)(vii) of the Act. The CIT(A) held that payment for restoration activities was to be assessed as business income and was taxable in India under Section 9(1)(i) of the Act. The CIT(A) estimated the Indian income from restoration activity at 10 per cent of the global receipts.

Taxability of standby maintenance services/charges

The Tribunal held that standby charges is a fixed annual charge, which is payable not for providing or rendering services albeit for arranging standby maintenance arrangement, which is required for a situation whenever some repair work on the under-sea cable or terrestrial cable is actually required to be performed or rendered. It is a facility or infrastructure maintained for ready to use for rendering technical services or for repairing services, if required. There is no actual rendering of the services qua the standby maintenance charges. Accordingly, following the earlier years' precedence, it was held that the receipt on account of standby maintenance charges was not chargeable as FTS within the scope of Section 9(1)(vii) of the Act.

Taxability of restoration services

In the present case restoration activity does not fall within the nature of 'managerial' or 'consultancy services', because there was no rendering or managing by direction, regulation, administration or supervision of activities by the taxpayer to VSNL. Further the taxpayer does not provide any advisory services for arranging of restoration activities to VSNL. The taxpayer already had a cable system network in which it had spare capacity, which was provided to VSNL in case of disruption in a cable network. When a restoration calling party like VSNL avails the network link in the cable of the taxpayer, no transfer of technology is involved nor have any technical services been rendered.

If any technical equipment developed by a human has been put to operation automatically, then usage of such technology per se cannot be held as rendering of technical services. Transmission of data or telecommunication traffic through a cable is not rendering of a technical service but the use of a technical device. Such a standard facility for transmission of data and telecommunication traffic by cable operators cannot be termed as rendering of technical services and therefore it was held that consideration received from restoration activities was not taxable as FTS under Section 9(1)(vii) of the Act.

Taxability as business income

A portion of the cable length falls within the territorial waters of India from where it connects to Mumbai and from there it again goes to other countries. In case of a sale of the capacity, the landing parties become the complete owner of the capacity to the exclusion of the taxpayer as held in earlier years. However, the spare capacity which lies in the cable belongs to the taxpayer, through which it had provided the restoration network to VSNL.

The Tribunal held that all the business operations of the taxpayer related with restoration services were not carried out in India. Therefore, reasonable attribution of income from such operations has to be done. In such a situation, Explanation 1A to Section 9(1)(i) provides that, in case of a business of which all operations are not carried out in India, then the income of the business shall be deemed to accrue or arise in India only such part of the income, which can be reasonably attributable to the operations carried out in India. The Tribunal upheld the method of attribution of tax department, however the AO is directed to determine the income of the taxpayer which is to be taxed in India after apportioning the revenue on the basis of length of the cable in the territorial waters in India on the segments on which restoration has been provided.

97. Outotec GmbH v. DDIT [2015] 172 TTJ 337 (Kol)

The taxpayer is a tax resident of Germany, engaged in the business of providing innovative and environmentally sound solutions for a variety of customers in the metals and minerals processing industry. During the Assessment Year (AY) 2010-11, the taxpayer earned revenue from the offshore supply of equipment to seven Indian companies (relating to the steel industry). Further the taxpayer sold drawings, designs and engineering documents to the customers for the operation and maintenance of the plant.

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The taxpayer had provided supervisory services in India and also was engaged by its customers for supervising the detailed engineering, installation and commissioning activity undertaken independently by the customer/third party vendors appointed by the customers. The taxpayer had a supervisory PE in India for supervisory services rendered on a standalone basis. Relating to supervisory services the taxpayer for the purpose of computation of profit for the AY under consideration computed the average profit margin earned by the comparable Indian companies, which worked out to 17.93 per cent of sales.

The AO held that the income earned by the taxpayer from the offshore sale of equipment accrues or arises in India and was taxable under the Act and the India-Germany tax treaty. The AO calculated a profit at 10 per cent of consideration from the offshore sale of equipment and held that it was chargeable to tax. Further, the AO held that the income earned from the supply of drawings and designs was taxable in India. Relating to supervisory services, the AO disregarded comparable companies adopted by the taxpayer and applied the net profit percentage at 27.5 as held by the Settlement Commission for Financial Years (FYs) 2007-08 and 2008-09.

The Tribunal held that income from offshore sale of equipment cannot be taxed in India either under the Act or under the India-Germany tax treaty, since all the activities relating to designing, fabrication, manufacturing and the sale of equipment took place outside India on a principal to principal basis. The consideration was also received outside India in foreign currency. Further, Indian customers were independent parties who made purchases on their own account and the transaction was made at arm's length.

The Tribunal held that sale of designs and drawings for setting up a plant amounts to the use of copyrighted article rather than the use of copyright and therefore, it is in the nature of business income. The designs and drawings sold by the taxpayer were used by Indian customers for internal business purposes for setting up of their plants and not for any commercial exploitation. Since the work relating to designs and drawings was done outside India and sale took place outside India, such income was not taxable either under the provisions of the Act or under the tax treaty.

For AYs 2008-09 and 2009-10 before the Settlement Commission and during the AY under consideration, the taxpayer admitted to have a PE in India to which the supervisory services were effectively connected, but no books of

accounts were maintained for the same. In such circumstances, the factual finding of the Settlement Commission towards attribution of profits to the extent of 27.50 per cent on the revenue earned from supervisory activities in India cannot be faulted with and for the very same reason, the action of the AO in attributing profits at 27.50 per cent was upheld.

98. ABB Inc. v. DDIT [2015] 69 SOT 537 (Bang)

The taxpayer is incorporated in the United States of America. It is engaged in providing business development, market services and other support services to its Associated Enterprises (AEs) in India. During the year under consideration, the taxpayer has earned fees for providing support services. In the income tax return, entire income was claimed to be, taxable exclusively in USA and not India under Article 12(4)(b) of the tax treaty. The AO held that the services rendered by the taxpayer are mostly consultancy services. The AO also observed that the taxpayer is providing technical services to its AEs and also makes available technical knowledge to the service recipients. Therefore, it was held to be in the nature of FTS under the Act and tax treaty. The DRP not only confirmed the stand of the AO on taxability of FTS but also held that the taxpayer has a dependent agency permanent establishment (DAPE) in India since the Indian AEs of the taxpayer act as agent of the taxpayer in purchasing the products of the taxpayer and distributes the same to various companies. Accordingly, the DRP held that a part is treated as business profits on account of DAPES estimated profits.

Tribunal's ruling

Fees for Technical Services

The law is settled in so far as the connotations of 'make available' clause in the definition of FTS under the tax treaties are concerned. The main condition for invoking 'make available' clause is that the services should enable the person acquiring the services to apply technology contained therein. The Karnataka High Court in the case of De Beers India (P.) Ltd.¹⁰⁸ approves this school of thought.

Unless there is a transfer of technology involved in technical services extended by the US based company, the 'make available' clause is not satisfied. Accordingly, the consideration for such services cannot be taxed under Article 12(4)(b) of the tax treaty.

¹⁰⁸ CIT v. De Beers India (P.) Ltd. [2012] 346 ITR 467 (Kar)

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The AO held that the services are technical services in nature. However, the decisive factor for determining the taxability of consideration under the tax treaty is not the training services *per se* but the training services being of such a nature that it results in transfer of technology. However, that was not the case in the present case.

It is not even suggestion of the AO that there was a transfer of technology in the present case so as to bring the services within the ambit of services which 'make available' technical knowledge, experience, skill and know how etc.

The lower authorities have been persuaded by normal connotations of the expression 'make available'. However, this expression has specific legal connotations, as held by the Karnataka High Court in the case of De Beers. In the light of the law so laid down by Karnataka High Court, the consideration for these services cannot be brought to tax under Article 12(4)(b) of the tax treaty as these services do not enable the recipient of the services to utilise the knowledge or know-how on his own in future without the aid of the service provider.

Permanent Establishment

The DAPE has been justified on the ground that its Indian affiliates, to which the services were rendered, were involved 'purchase and sale of 'Harmony' products of the taxpayer but the taxability is held to be in respect of the FTS rendered to these entities.

Even if a PE exists and the taxpayer carries on business through the PE, under Article 7(1) of the tax treaty, the profits of the taxpayer may be taxed in the source jurisdiction but only so much of them that are attributable to (i) PE (ii) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment (iii) other business activities carried on in the other State of the same or similar kind as those effected through that PE.

In the present case the PE is in respect of the trading transactions only and hence no part of the earning from rendering of services to the AEs can be related to the nature of the PE activities. Therefore, the consideration for these services can be brought to tax in the source jurisdiction i.e. India.

Coming to the question of taxability of the profit of the DAPE in the hands of the taxpayer, it is not even the case of the taxpayer that the Indian affiliate

has not been paid arm's length remuneration of services rendered by the Indian affiliate. Relying on the decision of SET Satellite (Singapore) Pte Ltd¹⁰⁹ it was held that the DAPE is paid an arm's length remuneration and therefore, payment cannot be brought to tax.

Even if there is a DAPE on the facts of this case, it will have no taxable profits to be taxed in the hands of the taxpayer in the absence of the finding that the DAPE has been paid remuneration less than arm's length remuneration. Accordingly, there was no need to examine the aspect regarding existence of the DAPE.

Accordingly, additions in respect of the income under Article 12(4)(a) as FTS and also in respect of income under Article 7(1) of the tax treaty has been deleted.

99. ITO v. Nokia India Private Limited (ITA No. 1941/Del/2012)

The taxpayer is a wholly owned subsidiary of Nokia Corporation. During the year under consideration i.e. AY 2006-07, the taxpayer, in the process of setting up a manufacturing facility at Chennai, had entered into a contract with Leighton Contractors India Private Limited (LCIPL) for the designing, manufacturing and completion of the manufacturing facilities. In order to ensure that the designs, construction plans, etc. prepared by LCIPL are in line with Nokia's global standards, the taxpayer entered into a contract with 'Olof Granlund Oy' (OG), a Finland based company, to review the same.

In relation to the payment made against the aforesaid services, the taxpayer did not withhold taxes on such payments on the ground that the said services availed from OG, Finland did not fall within the ambit of FTS, as defined under the tax treaty and hence was not liable to tax in India under the provisions of the Act read with tax treaty. Subsequently, the TDS officer has initiated proceedings under Section 195 of the Act and asked the taxpayer to show cause as to why the taxpayer should not be treated as an 'assessee in default' under Section 201(1) and 201(1A) of the Act for want of non-deduction of tax.

The taxpayer submitted that the services rendered by OG, Finland are towards the review of design and other related services and that no technical knowledge was made available to the taxpayer in this regard, and hence the same does not qualify as FTS under Article 13(4)(c) of the tax treaty. Further,

¹⁰⁹ SET Satellite (Singapore) Pte Ltd v. DDIT [2009] 307 ITR 205 (Bom)

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in the absence of a definition of 'make available' in the tax treaty, the taxpayer has placed reliance on the 'Memorandum of Understanding (MoU), concerning Fees for Included Services as per Article 12 of the India–U.S. tax treaty.

The taxpayer also contended that the said services would not be taxed under Article 7 read with Article 5 of the tax treaty in the absence of a PE of OG, Finland in India. However, the TDS officer, by placing reliance on the ruling of the Apex Court in the case of Transmission Corporation of AP¹¹⁰, held the taxpayer as an assessee in default under Section 201(1) of the Act. Aggrieved by the order of the TDS officer, the Company filed an appeal before the CIT(A). The CIT(A) affirmed the view taken by the taxpayer. A few takeaways from the order of the CIT(A) are outlined below:

The services provided by the non-resident are technical in nature as per the provisions of Section 9(1) (vii) of the Act.

Article 13(4)(c) of the tax treaty consists of two limbs, and there is a word 'or' between the two limbs. The services should fall under either of the two limbs before these could be termed as technical services.

As per the first limb of Article 13(4)(c) of the tax treaty, the words 'make available' qualify the technical services and unless this qualification is satisfied, the services which are otherwise technical in nature cannot be termed as technical services under the said article of the tax treaty.

As per the contract, the services provided are in the nature of review of designs and technical plan and hence the nature of services provided do not fall in the second limb either i.e. the development and transfer of a technical plan or a technical design.

In view of the above, and adding to the fact that OG, Finland does not have a PE in India, the CIT(A) held that the provisions of Section 195 of the Act are not triggered and hence the taxpayer cannot be deemed as an assessee in default.

Tribunal's ruling

The Tribunal held that to determine whether the payments fall under Article 13(4)(c) of the tax treaty, it is imperative to determine whether the services 'make available' any technical knowledge, experience, skill, etc. to the

¹¹⁰ Transmission Corporation of AP Limited v. CIT (1999) 239 ITR 587 (SC)

recipient of the service or if it involves the development and transfer of a technical plan or design to the recipient of the services.

The tax treaty does not specifically define the term 'make available'. In the absence of the same, a reference can be drawn from the MoU to India – U.S tax treaty, in line with the principle of parallel treaty interpretation. Previously, various courts¹¹¹ have held that parallel treaty interpretation is permissible where the language of two treaties is similarly worded and where one treaty clarifies the meaning of the terms used.

The MoU seeks to clarify that the services are considered to be made available only where it leads to a transfer/impart of technical knowledge, experience, skill, know-how or process to the recipient, which enables the recipient to apply the same on its own.

The services rendered by OG, Finland are merely to ensure that the design and construction plans to be installed at the taxpayer's factory in Chennai are of the right design and quality and in line with Nokia's global standards, and are neither geared to nor do they 'make available' any technical knowledge, skill or experience to the taxpayer.

Further, in absence of a PE of OG, Finland in India under the provision of Article 5 of the tax treaty during the subject period, the same would not be taxed as 'Business Profits' under Article 7(1) of the tax treaty.

With respect to the other issue of applying and seeking a certificate for lower withholding tax order for such payments, the Hon'ble ITAT by placing reliance on the decision of the Apex court in the case of GE India Technology Centre P. Ltd¹¹² held that there is no requirement of seeking such lower/nil withholding tax certificate if the whole of such payment is not chargeable to tax in India.

Based on the above, the Tribunal held that the payments made by Nokia India to OG, Finland towards reviewing design/drawings to ensure that they are of the right quality, are not in the nature of FTS as per Article 13(4)(c) of the tax treaty since OG, Finland has not 'made available' any technical

¹¹¹ National Organic Chemical Industries Ltd v. DCIT [2005] 96 TTJ 765 (Mum), CESC v. CIT [2003] 80 TTJ 806 (Cal), DDIT v. Prenoy A.G. [2010] 39 SOT 187 (Mum), Intertek Testing Services India (P) Ltd., In re [2008] 307 ITR 418 (AAR)

¹¹² GE India Technology Centre P. Ltd (Civil Appeal Nos.7541-7542 of 2010)

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knowledge or experience that could in turn enable Nokia India to use it independently in its business without recourse to OG, Finland.

100. SkillSoft Ireland Limited [2015] 376 ITR 371 (AAR)

The applicant is an Ireland based company, engaged in the business of providing on demand e-learning course offerings, online information resources, flexible learning technologies and performance support solutions (SkillSoft products). The applicant has entered into a reseller agreement with SkillSoft Software Services India Private Limited (SkillSoft India). Under this agreement, SkillSoft India is a distributor and has the right to license, market, promote, demonstrate and distribute SkillSoft products by providing online access to such products.

SkillSoft India buys the SkillSoft products from the applicant on a principal-to-principal basis and sells the same to Indian end users/customers in its own name. According to the applicant, it has developed copyrighted products by using software and techniques, on several topics which were electronically stored on its server outside India. These SkillSoft products are licensed to Indian end users/customers under the master licence agreement between SkillSoft India and Indian end users. SkillSoft India grants to the Indian end users a non-exclusive, non-transferable license to use and to allow the applicable authorised audience to access and use SkillSoft products. The products consist of two components namely the course content and the software through which the course content is delivered to the end customer. Its e-learning platforms are not instructor driven and have no element of human interaction in the learning programmes. The interaction is restricted to software enabled virtual interaction through text, images and graphics that are utilised to enhance the learning experience.

The issue before the AAR was whether payments received by the applicant on account of e-learning course offerings, online information resources, etc. is taxable as 'royalty' under Article 12(3)(a) of the India-Ireland tax treaty.

The AAR held that e-learning course offerings, online information resources, etc. are software and computer databases created by the applicant, included within the ambit of 'literary work' under Article 12(3)(a) of the India-Ireland tax treaty. Irrespective of the use of words like 'non-exclusive' and 'non-transferable' in the relevant agreements, there is a transfer of certain rights owned by the applicant. In terms of the tax treaty, the consideration paid for the use or a right to use the confidential information in the form of computer

software, itself constitutes royalty. Accordingly, payment for e-learning courses and online information resources is taxable as royalty under the India-Ireland tax treaty.

101. Measurement Technology Ltd. [2015] 376 ITR 461 (AAR)

The applicant is a company incorporated in the UK and is engaged in the development and supply of intrinsic safety explosion protection devices, field bus and industrial networks, etc. The applicant is a wholly owned subsidiary of MTL Instruments Group Ltd., UK (MTL UK).

MTL Instruments Private Limited (MTL India) is an Indian company, and a subsidiary of MTL UK. MTL India is engaged in the business of manufacturing industrial control equipment used for process control in hazardous environments. The applicant entered into two service agreements with MTL India for providing management and procurement services.

The management services were provided through one of the employees of the applicant based in the UK designated as Group Operations Director (GD) by means of telephone calls, e-mails and occasional visits to India. While sitting in the UK, the GD monitors the financial and operational progress of activities of MTL India. The GD also renders services as regards human resource matters of MTL India such as hiring new personnel, setting up individual performance targets, assisting in performance appraisal, etc. The GD was also involved in quality and design reviews. As per this agreement, MTL India shall compensate the applicant for providing the management services at cost plus 5 per cent and for this purpose only 50 per cent of the cost (total remuneration of the GD) is allocated by MTL UK.

The second agreement was entered for provision of procurement services with a view to reduce cost and to avoid duplication of procurement efforts within the MTL Group. As per the agreement, the applicant had constituted a procurement team in the UK to look into the global sourcing requirements of raw materials within the MTL Group including MTL India. The procurement team travels to different countries to visit suppliers and distributors to determine the best price that would be available to MTL group. Their services include setting up the material supply chain, logistic support and providing support to resolve technical issues with supplies from global sources. MTL UK was compensated for the procurement services on a cost to cost basis (without any mark-up) and for this purpose only 30 per cent of the cost of the procurement term was allocated to MTL India.

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The AAR held that the consideration received by the applicant for management and procurement services is not taxable in India as per the provisions of the India-UK tax treaty since such services do not make available any technical knowledge, skills, etc. The Authority for Advance Rulings (AAR) also observed that managerial services are not covered in the definition of FTS in the India-UK tax treaty and the same are routine managerial activities and cannot be classified as technical or consultancy services. Further, the AAR observed that procurement services can never be classified as technical or consultancy in nature and therefore, such services are not FTS under the tax treaty.

102. DCIT v. Carl Zeiss India (P) Ltd. (IT(IT)A No.1251(B)/2014) (Bang)

The taxpayer, a company incorporated in Singapore, is a 100 per cent subsidiary of Carl Zeiss, AG Germany. The Carl Zeiss group manufactures and sells optical products. The taxpayer was engaged mainly as a front office for Carl Zeiss group in India. The branch office of the taxpayer in India facilitates the sale of Carl Zeiss group products in India, apart from providing sales support to its products in India.

During the year under consideration the branch of the taxpayer had made payment of reimbursement of the expenditure in respect of the services rendered by head office through three senior management officials. The payment was made under the cost sharing arrangements and claimed as reimbursement to the head office. The branch obtained a nil withholding tax certificate from the tax officer before remitting the amount to its head office.

The AO held that the services provided by the head office through three senior management officials fall within the category of FTS under Section 9(1)(vii) of the Act as well as India-Singapore tax treaty. Since the taxpayer did not deduct tax at source, the said payment was disallowed under Section 40(a)(i) of the Act and added to the total income.

The Bangalore Tribunal held that the taxpayer had remitted the amount to the non-resident after obtaining a certificate from the tax officer under Section 195(2) of the Act. The tax officer while granting the certificate under Section 195(2) had duly recorded the fact that the payment in question is in connection with salaries and other cost of managerial and HR officials charged to Indian branch which includes the cost of MD, Chief Officer, HR & Quality and web administrator for IT application specialists. Thus, after considering the submissions of the taxpayer that the services provided by the

non-resident from Singapore does not fall within the definition of FTS under Article 12 of India-Singapore tax treaty, the tax officer issued a 'nil' withholding certificate for making remittance. Once the taxpayer had complied with the provisions of Section 195 of the Act and obtained a certificate from the tax officer in accordance with the requirement of Section 195(2) then, the taxpayer cannot be penalised by invoking the provisions of Section 40(a)(i) of the Act during assessment.

Accordingly, without going into the issue of the nature of payment whether FTS or not, it was held that once the taxpayer had complied with the provisions of Section 195 by obtaining the certificate under Section 195(2) of the Act, no disallowance can be made under Section 40(a)(i) of the Act with respect to the said amount paid to the non-resident.

103. IMG Media Limited v. DDIT [2015] 173 TTJ 591 (Mum)

The taxpayer, a tax resident of U.K., is a world leader in the field of multimedia coverage of sports events including cricket. The taxpayer and the Board of Control for Cricket in India (BCCI) had entered into an agreement for capturing and delivering of the live audio and visual coverage of cricket matches conducted under the brand name Indian Premier League (IPL). The taxpayer had contended that there existed a service PE and income attributable to the Indian operations was computed under Transactional Net Margin Method (TNMM). However, the AO held that the amount received by the taxpayer was in the nature of FTS and also in the nature of 'royalty' and accordingly taxed the entire amount of gross receipts. The Dispute Resolution Panel (DRP) held that the concept of 'Service PE' does not have an application, once it is held that the gross receipts are taxable as FTS or as 'royalty'. The DRP held that the amount received by the taxpayer was in the nature of FTS under the Income-tax Act, 1961 (the Act) and the India-U.K. tax treaty.

Tribunal's ruling

Fees for Technical Services

It has been observed that the taxpayer produces the feed (program content) of live coverage of audio-video visuals of the cricket matches by using its technical expertise. After that it delivers the feed (program content) in the form of digitalised signals to the licensees (broadcasters). There was no dispute that the licensees (broadcasters) receive the feed on behalf of the BCCI. What is delivered by the taxpayer is a 'final product in the form of

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program content' produced by it by using its technical expertise. The taxpayer does not deliver or make available any technology/knowhow to the BCCI.

It was not disputed that the production of 'program content' by using technical expertise is altogether different from the provision of technology itself. In the former case, the recipient would receive only the product and he can use it according to his convenience, whereas in the later case, the recipient would get the technology/know-how and hence he would be able to use the technology/knowhow on his own in order to produce any other program content of similar nature.

In the present case the tax department has not established that the broadcasters (who are acting on behalf of the BCCI) or the BCCI itself has acquired the technical expertise from the taxpayer which would enable them to produce the live coverage feeds on their own after the conclusion of IPL cricket matches. In that case the essential condition of 'make available' clause fails and hence the amount received by the taxpayer cannot be considered as FTS under Article 13(4)(c) of the India-U.K. tax treaty.

Royalty

The Tribunal observed that the tax department had not brought any material on record to show that the taxpayer had kept the ownership rights over the program content. The tax department had noticed that the BCCI was required to supply certain equipments and therefore held that it would be taxable as equipment royalty under the Act as well as the tax treaty. However, the rationale behind this observation was not clear. If the taxpayer was using the equipments belonging to BCCI and if that activity is examined in isolation, then the taxpayer should be paying money to BCCI for using the equipments. In the present case, the taxpayer has received the money for producing live coverage of cricket matches.

A careful perusal of the definition of 'royalties' under the tax treaty indicates that the payment, in order to constitute royalty, should have been made 'for the use of, or the right to use any copyright etc'. However, in the instant case, the payment was made by BCCI to the taxpayer for producing the program content consisting of live coverage of cricket matches. There was nothing on record which indicates that the taxpayer had retained the ownership of the program content.

The Tribunal relied on the decision of the Delhi High Court in the case of CIT v. Delhi Race Club [2015] 273 CTR 503 (Del). The Tribunal observed that

though the said decision was rendered in the context of provisions of Section 194J of the Act, yet section imports the definition of the term 'royalty' from Explanation 2 to Section 9(1)(vi) of the Act. In the present case, the BCCI becomes the owner of the program content produced by the taxpayer. The job of the taxpayer ends upon the production of the program content and the broadcasting is carried out by some other entity to which license was given by the BCCI. Hence, the question of transfer of all or any right does not arise in the facts and circumstances of the instant case. Accordingly, the payment received by the taxpayer cannot be considered as 'royalty' under the tax treaty.

104. Guangzhou Usha International Ltd. [2015] 378 ITR 465 (AAR)

The applicant is a company registered under the laws of China. The share capital of the applicant is held by Usha International Limited (UIL), having its registered office in India. The applicant has been set-up to carry on the business of import and export and also to provide services relating to the business of household electrical appliances and equipments, household goods and accessories etc. to the Indian company. The applicant had entered into a Memorandum of Understanding (MOU) with UIL for providing services in connection with the procurement of goods by UIL from vendors in China. Subsequently, the MOU was converted into a service agreement. In terms of the service agreement, the applicant has to render services to UIL in the form of new supplier's development, new products development, market research, price, payment term, safety/performance/endurance test, review of quality system, inspection through SGS, interaction with vendors, information sharing with UIL. UIL while making the payment of service fee to the applicant company had deducted tax at source at the rate of 10 per cent, considering the payment in the nature of FTS under the tax treaty. The applicant filed an application before the AAR on the issue of whether service fees received for providing services in connection with procurement of goods are taxable in India.

The AAR referred to the India-China tax treaty and China-Pakistan tax treaty and observed that it is necessary to point out the distinction between the two tax treaties. In India-China tax treaty, the expression used is 'provision of services of managerial, technical or consultancy nature' while in the China-Pakistan tax treaty the expression used is 'provision of rendering of any managerial, technical or consultancy services'. The AAR observed that the expression 'provision of services' is not defined anywhere in the tax treaty. It

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is concerned only with the India-China tax treaty. Any other tax treaty either between India and other country or between China and other country cannot influence the scope of the India-China tax treaty. The distinction between these two tax treaties clearly points out that the scope of 'provision of services' as in the India-China tax treaty is much wider than that of 'provision of rendering of services' as in the Pakistan-China tax treaty. Based on this distinction, the AAR in the case of Inspectorate (Shanghai) Limited [AAR No.1005 of 2010] held that 'provision of services' will cover the services even when these are not rendered in the other contracting state (i.e. India in this case) as long as these services are used in the other contracting state (i.e. India in this case).

On a perusal of the list of services provided in the service agreement, it indicates that the applicant is not only identifying the products but also generating new ideas for UIL after conducting market research. It is also evaluating the credit, organisation, finance, production facility, etc. and based on this evaluation it is giving advice in the form of a report to UIL. Such an evaluation can only be given by an expert in the specific area. The applicant is also providing information on new developments in China with regard to technology/product/process upgrade. These are specialised services requiring special skill, acumen and knowledge. These services are definitely in the nature of consultancy services. Accordingly, it has been held that the amount of service fees received by the applicant from UIL for providing consultancy services is taxable in India.

105. Cincom System Inc. v. DDIT [ITA No. 952/Del/2006, AY: 2002-03] (Del)

The taxpayer is a foreign company engaged in the business of providing software solution including creating personalised document, management of solutions, etc. The taxpayer entered into the 'Communication Agreement' with Cincom Systems (India) Pvt. Ltd. wherein it was agreed that the taxpayer shall provide access to Cincom Systems (India) Pvt. Ltd. to the internet and other email and networking facilities along with other group concern. In consideration of providing these services, the taxpayer was paid a certain sum. For the AY 2002-03, the taxpayer company offered such amount as FIS. However, before the CIT(A), the taxpayer contended that the amount was not taxable in India. The CIT(A) held that the payment was not in the nature of FIS, however, held that it was in the nature of royalty.

The Tribunal observed that the AAR in the case of *Abc* [1999] 238 ITR 296 (AAR) held that the definition of the expression 'royalty' under Section 9(1)(vi) of the Act read with clause (vi) of the Explanation includes rendering of any services in connection with any activities for the use of any patent, invention, secret formula or process, etc. In the instant case, the concept of 'source' against 'residence' becomes more significant as the issue relates to cyberspace activities. The transmission of information was through encryption as the data relates to clients and strict confidentiality was observed. It was for the downloading of the software that the royalty is paid. In this context, the source rule becomes relevant which requires that royalty is sourced in the state of the payer. According to the agreement between the American company and the Indian company, the facilities were to be accessed only by the Indian company. The consideration payable was for the specific programme through which the Indian company was able to cater to the needs of the group companies located in Japan and other places. The transaction would be related to a 'scientific work' and would partake the character of intellectual property and therefore, in the character of royalty. The software was customised and a secret. From the facilities provided by the American company to the Indian company, which were of the nature of online, analytical data procession, it would be clear that the payment was received as 'consideration for the use of, or the right to use design or model, plan, secret formula or process'. The use by the Indian company of the CPU and the consolidated data network of the taxpayer was not merely 'use of or the right to use any industrial, commercial or scientific equipment' as envisaged in Article 12(3)(b) of the tax treaty but more than that.

It was the use of embedded secret software (an encryption product) developed by the American company for the purpose of processing raw data transmitted by the Indian company, which would fall within the ambit of Article 12(3)(a) of the tax treaty. The reliance placed by the taxpayer on the decision of the Delhi High Court in the case of *Asia Satellite Telecommunication Co. Ltd. v. DIT* [2011] 332 ITR 340 (Del) is totally misplaced. Accordingly, the ratio of the ruling of AAR in the case of *Abc* was applicable in the present case and the consideration paid was in the nature of royalty within the meaning of Article 12(3) of the tax treaty.

106. IHI Corporation v. ADIT [2016] 156 ITD 677 (Mum)

The taxpayer, a company incorporated in and tax resident of Japan, was engaged in the manufacturing of heavy machinery, providing technology

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oriented products and services. The taxpayer was awarded three EPC and commissioning contracts by Petronet LNG Limited in India. The contract consideration under these agreements is segregated into an offshore and onshore portion. The onshore portion comprises of onshore supply of equipments and services in India while the offshore portion comprises of the offshore supply of equipment and services from outside India. For the purposes of the execution of this contract the taxpayer set-up a project office in India. In the return of income, the taxpayer offered the income received from onshore activities to tax in India with a claim of the applicability of the tax treaty or the domestic law, whichever is beneficial to it. The taxpayer did not offer to tax the income from offshore supply offshore services by claiming that it did not accrue or arise in India. In support of its contention, the taxpayer relied on the Supreme Court decision in its own case¹¹³. The taxpayer claimed an exemption of income from offshore services from tax by stating that its project office in India had no role to play in respect of the offshore services rendered. The Assessing Officer (AO) as well as the Dispute Resolution Panel (DRP) opined that the Supreme Court's decision in the taxpayer's own case was rendered prior to the retrospective amendment carried out to Section 9(1)(vii) of the Act. Also, the amount was liable to be considered as FTS under Article 12 of the tax treaty. Resultantly, the gross sum received by the taxpayer towards offshore services was subjected to tax at 10.5575 per cent.

The Tribunal's ruling

Taxation under the Act

The Finance Act, 2010 has substituted the Explanation below Section 9(2) of the Act, whereby the income from FTS shall be deemed to accrue or arise in India to a non-resident whether or not, inter alia, the non-resident has rendered services in India.

The substitution of this Explanation has diluted the twin conditions formulated by the Supreme Court in the taxpayer's own case, being the rendering of services and the utilisation of such services in India as a pre-requisite for attracting Section 9(1)(vii) of the Act. With this substitution, the rendering of services even outside India would be a good case for bringing the income of non-residents from FTS within the purview of Section 9(1)(vii) of the Act, if such services are utilised in India.

¹¹³Ishikawajima-Harima Heavy Industries Ltd. v. DIT [2007] 288 ITR 408 (SC)

In view of above, income from offshore services rendered outside India would fall within the domain of Section 9(1)(vii) of the Act.

Taxation under the tax treaty

Article 12(5) of the tax treaty is a center of controversy between the assessee and the tax department, which contended that the case of the taxpayer cannot be considered under Article 12(5) because the fees for offshore services cannot be considered as 'effectively connected' with the Permanent Establishment (PE).

The taxpayer contended that the offshore services were rendered because of the composite 'contract', whose remaining parts are effectively connected with the PE in India. It was submitted that if the effective connection of the FTS and the PE is established, then the income goes back to Article 7 instead of staying in Article 12 of the tax treaty.

The Supreme Court in the taxpayer's own case held that:

For Section 9(1)(vii) of the Act to be applicable, it is necessary that the services not only be utilised within India, but also be rendered in India or have such a 'live link' with India that the entire income from fees as envisaged in Article 12 of the tax treaty becomes taxable in India.

The terms 'effectively connected' and 'attributable to' are to be construed differently, even if the offshore services and the PE were connected.

Article 7 of the tax treaty is applicable in this case, and it limits the tax on business profits to that arising from the operations of the PE. In this case, the entire services have been rendered outside India, and have nothing to do with the PE; thus it cannot be attributable to the PE and therefore not taxable in India.

The Supreme Court has rendered a positive decision on this aspect by holding that Article 7 of the tax treaty is applicable in this case insofar as the income from offshore services is concerned. It has further been held that since the entire service was rendered outside India having nothing to do with the PE, this amount cannot be taxed in India.

Further, the offshore services are inextricably linked to the supply of goods, so it must be considered in the same manner. In view of the enunciation of law by the Supreme Court in the taxpayer's own case, it becomes vivid that the income from identical services rendered by the taxpayer in respect of the contract under consideration cannot be characterised differently.

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In the Assessment Year (AY) 2003-04, the jurisdictional High Court noted that the Supreme Court in the taxpayer's own case had held that apart from the non-applicability of Section 9(1)(vii) of the Act, Article 7 of the tax treaty is also applicable and hence the income arising on account of offshore services would not be taxable.

The Supreme Court in the case of P.V.A.L. Kulandagan Chettiar¹¹⁴ held that the provisions of Sections 4 and 5 are subject to the contrary provision, if any, in the tax treaty. The crux of the matter is that the provision of the Act or that of the tax treaty, whichever is more beneficial to the taxpayer, shall apply.

Accordingly, it was held that the income from offshore services, albeit chargeable under Section 9(1)(vii) but exempt under the tax treaty, cannot be charged to tax in the light of Section 90(2) of the Act.

Applicability of the DTAA

1. Bid Services Division (Mauritius) Ltd., *In re* [2020] 114 taxmann.com 434 (AAR - Mumbai) Dated 10 February 2020

Airport Authority of India ('AAI'), with the approval of Government of India, selected the applicant in Consortium with GAHPL and AGL and ACSA as joint venture partners for undertaking development, operation and maintenance Activities at 'Mumbai Airport' AAI also entered into an Operation, Management and Development Agreement ('OMDA') with Mumbai International Airport Private Limited ('MIAL') to undertake said Activities at Mumbai Airport.

A Shareholder Agreement was entered into between the Applicant, AAI, GAHPL, AGL and MIAL, inter alia, for the purpose of governing their relationship in their mutual capacity as the shareholder of MIAL. Under such agreement, the applicant agreed to subscribe and acquire 27 per cent of the total issued and paid-up share capital of MIAL.

The applicant has subsequently entered into a Share Purchase Agreement ('SPA') with GAHPL and GVK, the companies incorporated under the India Companies Act, 1956 wherein the applicant has agreed to sell and transfer to GHPL and GAHPL 13.5 per cent of the total paid-up share capital of MIAL.

The applicant seeks advance ruling on question as to whether gain arising from the transaction of sale of share, to be effected pursuant to the Share

¹¹⁴CIT v. P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654 (SC)

Purchase agreement held by the Applicant in 'MIAL' would be liable to tax in India having regard to the provision of Article 13(4) of India-Mauritius DTAA.

AAR Ruling

The doctrine of substance over form mandates taxing transaction pursuant to its economic effect rather than its form and that a valid transaction must have both substantial purpose apart from reduction of tax liability.

In the instant case the applicant was incorporated few days before the JV was formed and has no independent sources of funds or sources of income or has any fiscal independent. All the funds are with the holding companies. The applicant has no tangible assets, business activities except for owing the shares of the JV. Subjecting the facts to various tests i.e., Fiscal nullity Test, Commercial/business substance Test, "Look at" Principal Test, Investment participation Test, time duration Test, Business operations Period in India Test, Generation of taxable revenue in India Test, Scheme and Dominant Purpose Test etc., the applicant fails these tests being a tax avoidance device, the dominant purpose of its interposing is to avoid taxation in India.

Once it is established that the applicant company is interposed as a device, it is open to the Department to discard the device and take into consideration the real transaction between the parties and the transaction would be subjected to tax.

In view of aforesaid, it is ruled that the applicant is not entitled to benefit under article 13(4) of Indo-Mauritius DTAA in regard to gains arising from the transaction of sale of shares in question.

2. Tiger Global International II Holdings, *In re* [2020] 116 taxmann.com 878 (AAR - New Delhi) Dated 26 March 2020

The applicants were private companies, limited by shares incorporated under the laws of Mauritius. They were set up with the primary objective of undertaking investment activities with the intention of earning long-term capital appreciation and investment income

The applicants had been granted a Category 1 Global Business License and were tax residents of Mauritius

The applicants held shares in a private company (Flipkart Private Limited), limited by shares incorporated under the laws of Singapore.

The applicants transferred certain shares of Singapore company (SCo) to a Luxembourg based company (Fit Holdings S.A.R.L)

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The transfers were undertaken as part of a broader transaction involving the majority acquisition of SCo by a company incorporated in the US (Walmart Inc.), from several shareholders, including the applicant.

The applicants filed an application before the AAR for an advance ruling on the question that whether gains arising to the applicants (i.e. private company incorporated in Mauritius) from the sale of shares held by it in SCo would be chargeable to tax in India under the Income-tax Act, 1961 read with India-Mauritius tax treaty.

The tax department's objected to admissibility of the application on three grounds as per the provisions of section 245R of the Act, i.e.

- (i) proceedings were pending before the income-tax authority or appellate tribunal or court
- (ii) it involved determination of fair market value (FMV)
- (iii) transaction or issue was designed prima facie for avoidance of tax

The AAR rejected tax department's contentions on 'pendency of proceedings' and 'determination of FMV'

The tax department's contentions on whether the transaction / issue designed prima facie for avoidance of tax is as follows:

Ownership structure and control

The applicants were held by a US-based investment entity Tiger Global Management LLC (ABC LLC), that invests in public and private markets across the world through a web of entities based out of low tax jurisdictions in Cayman Islands and Mauritius. The applicants were set up for:

- Making investment in India and that the funds for making investment were provided by the promoter.
- Claiming benefit under the India-Mauritius tax treaty.

Thus, the tax department argued that the real control of the applicants does not lie within Mauritius and the applicants were not acting independently but only as a conduit for the real beneficial owners based out of the US.

Decision Making

All board meetings in which crucial decisions were taken was attended by:

- Mr. X, a non-resident USA director (who was also the general counsel of ABC LLC)
- Mr. X or one of the representatives of the ABC LLC was always present to advise the board of the applicants.

Thus, the Mauritius directors were mere puppets and not independent and took advice from Mr. X.

Financial Control

In addition to Mr. X, the applicants had appointed two more authorised signatories (Mr. Y, Founder Member and partner of ABC LLC and Mr. Z, Chief Operating officer of ABC LLC) for all transactions above USD 250,000.

- Both Mr. Y and Mr. Z were not on board of the applicant but were key personnel of ABC LLC.
- Mr. Y was also the authorised signatory for the immediate parent companies and was also the sole director of the ultimate holding company.

Hence, the tax department argued that the funds were controlled by Mr. Y and under his overall control by other senior personnel of ABC LLC.

Beneficial Ownership

At the time of obtaining global business licence in Mauritius, the applicant had submitted that Mr. Y is the beneficial owner of the applicant.

Other Arguments

- Treaties should be interpreted in good faith. Therefore, the good faith interpretation of these treaties requires the element of tax avoidance and treaty abuse to be examined by the tax administration while invoking treaty provisions.
- If ABC LLC directly held shares in SCo, it would have been liable to pay tax on gain on sale of those shares.
- Considering the peculiar facts and circumstances of the case, it was entitled to disregard form of the arrangement and re-characterise the transfer of shares according to its economic substance and thereby, tax the actual controlling nonresident enterprise.
- The tax department concluded its arguments by stating that the applicants were a 'see-through entity' and the transaction was designed for avoidance of tax.

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Applicant's contentions

- The transaction involved was sale of shares undertaken between two unrelated independent parties which cannot be considered as being designed for the avoidance of tax.
- It must be proven that the transaction itself and not the structure of the entity undertaking the transaction was designed for the avoidance of income-tax.
- A transaction cannot be designed for the prima facie avoidance of tax if there is business rationale surrounding the transaction.
- Holding structure of the applicant was of no relevance and the transaction was not prima facie found to be designed for avoidance of tax.
- The applicants had beneficially held shares of SCo and were not accountable to any third party.
- The applicant was managed and controlled by its board in Mauritius in accordance with its constitution.
- The decision to invest and ultimately sell the shares of SCo was taken by the directors in Mauritius after proper discussions and deliberations.
- The mere fact that the board have given a limited authorisation to certain persons to operate the bank account does not ipso facto mean that the applicants did not have control over its funds.
- The department has not been able to establish that the funds invested as well as the sale proceeds received from the transaction were legally and beneficially owned by the applicants in its sole, independent and exclusive capacity.
- The mere fact that certain disclosures were made and maintained for Mauritius corporate law purposes does not mean that the legal owner does not enjoy the benefits of the shares in its independent capacity for income tax purposes.
- The logic adopted by the tax department would result in an absurd and legally unintended situation, whereby no Indian company with foreign shareholders would ever be able to claim treaty benefits in India.

AAR Ruling

- The requirement for rejecting an application is not to conclusively establish that there was tax avoidance, rather it has to be demonstrated that prime facie the transaction or the issue was designed for avoidance of tax.
- The applicant's contention that the issue only pertains to sale of shares is too simplistic to be accepted. The precise question raised in the application is chargeability of capital gains on sale of shares under the Act read with India-Mauritius tax treaty. Thus, it would involve looking at the transaction as a whole, i.e. both the purchase and sale.
- The principal objective of the applicant was to act as an investment holding company for a portfolio investment domiciled outside Mauritius. The investment made by the applicants in SCo, with an Indian subsidiary, was with a prime objective to obtain benefits under India-Mauritius tax treaty and the treaty between Mauritius and Singapore.
- Although a holding-subsidary structure might not be a conclusive proof for tax avoidance, the purpose for which the subsidiaries were set up indicates the real intention behind the structure and that the applicants were set up for making investment in order to derive benefit under the India-Mauritius tax treaty.
- In order to ascertain the control and management of the applicants, it is necessary to understand where the 'head and brain' of the applicants is situated. In this regard, the AAR has referred to the following facts :
 - Overall control of the companies vis-à-vis routine control of affairs must be determined.
 - The authority to operate bank accounts for transactions above USD 250,000 was with Mr. Y. Considering the principal account of the applicants is maintained in Mauritius, a local person authorised to operate the bank accounts would have been more prudent.
 - Mr. Y was also the beneficial owner of the applicants as disclosed earlier.
 - Mr. Y was also the authorised signatory of the immediate parent

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- company of the applicant and the sole director of the ultimate holding company.
- This proves that the funds of the applicant were ultimately controlled by Mr. Y.
 - Therefore the 'head and brain' of the company viz. their control and management was situated in USA and not Mauritius.
 - The applicant companies were only a 'see through entity' to avail the benefits of India-Mauritius tax treaty.
 - A tax treaty should be interpreted in good faith. Accordingly, the benefit under India-Mauritius tax treaty (both under amended as well as unamended treaty) was available to a resident of Mauritius earning capital gains from sale of shares of Indian company. However, in the present case, capital gain is arising on the sale of shares of SCo.
 - Since exemption from capital gains tax on sale of shares of foreign company was never intended under the original or the amended tax treaty, the applicant were not entitled to claim benefit of capital gain tax exemption on the sale of shares of SCo.
 - Since there was no foreign direct investment made by the applicant in India, there cannot be any question of participation in investment. In the absence of any direct investment in India one can only conclude that the arrangement was a preordained transaction which was created for tax avoidance purpose.
 - Thus, the AAR held that question raised in the present application was designed prima facie for avoidance of tax.
 - The applicants had contended that since shares of the SCo derived their value substantially from assets located in India, it was eligible to take benefit of Article 13(4) of India-Mauritius tax treaty. Here, the AAR maintained that the fact remains that what the applicants had transferred was shares of SCo and not that of an Indian company.
 - Therefore, it concluded that the entire arrangement made by the applicant was with an intention to claim benefit under India-Mauritius tax treaty, which was not intended by the lawmakers, and such an arrangement was nothing but an arrangement for avoidance of tax in India. Therefore, the AAR rejected the application made by the applicants.

3. M.A. Rafik In re, P. No. 206 of 1994 213 ITR 317 [1995] (AAR)

The applicant was a Non-resident Indian residing in Dubai with his wife and children. There is no law imposing income-tax on individuals in Dubai. The applicant had a dwelling house in India, which he used during his occasional visits to India. He was working in Dubai as Manager of a firm of Chartered Accountants. He derived share of income from two firms in India, which was exempt from tax under Section 10(2A) of the Act. He also derived income in India from interest, dividends on shares, income from bonds, debentures and other securities.

The following questions were raised before the AAR:

- (i) Whether the applicant, an individual residing in the U.A.E. is entitled to claim the benefits of the provisions of treaty between India and U.A.E.?
- (ii) Whether the applicant is liable to capital gains on movable assets in India in terms of Article 13(3) and Article 4 of the treaty between India and U.A.E.?
- (iii) Whether the applicant is liable to capital gains tax on transfer of movable assets like shares, debentures, etc. Under section 112 of the Act, read with the provisions of the DTAA between India and UAE.?
- (iv) Whether in terms of the treaty with U.A.E. is applicant liable to capital gains tax on shares, debentures, etc. if they were (a) Acquired prior to the notification of the treaty; (b) Acquired prior to his becoming a non-resident; (c) After his becoming non-resident, buys shares, debentures, etc. acquired out of non-repatriable funds in India.
- (v) Whether in terms of treaty (Article 10) is dividend received from India liable to tax at 15percent?
- (vi) Whether in terms of Article 11 of the treaty, interest on debentures, bonds, balance in capital account in partnership firm liable to tax in India at 12.5percent?

The AAR observed that the fact that there was no income tax or wealth tax on individuals in any of the Emirates was well known, in spite of which the Central Government choose to enter into full-fledged treaty on comprehensive basis. Both the states entered into this Comprehensive Treaty with clear knowledge that there is no income tax or wealth tax in the

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UAE on individuals. This was with the intention to encourage inflow of funds from Dubai to India for investment. In this context, it is necessary to remember that U.A.E. provides one of the largest export markets for India in West Asia. India was also in the process of looking out for foreign countries interested in investing in India and must have considered the DTAA as providing an opportunity to improve the economic relations, between the two countries and encourage the flow of funds from Dubai. Any incentive offered in respect of Dubai would also attract investments from the other countries in the region, which could hope for DTAA on similar lines.

Given the clear knowledge on the part of India that individual Indian investors in U.A.E. paid no, or only a nominal, income-tax on their income, the only purpose of the DTAA was clearly to provide some benefits to all U.A.E. investors in India. Read against this background, Articles 10 and 11 clearly envisage a lower rate of income-tax to all U.A.E. investors on such investments and Article 13 clearly leaves it to the U.A.E. to deal with the capital gains on movable property realised by all U.A.E. investors. The very fact that the DTAA was signed with eyes open that there was no tax on individuals in the UAE, and the presence of number of Articles (10-11-13 to 21) indicate that the DTAA was an agreement intended to be applicable to individuals from the very date of its coming into force and was not intended to be a dead letter until appropriate legislation brought them into the tax net in the UAE. Article 4(1) is to be interpreted in this background. A person was liable to tax in the state by reason of his domicile, residence, place of incorporation or place of management or any other criterion of similar nature did not connote an actual taxation measure but connoted a person who was liable to be subjected to tax by the taxation laws of that State because of a nexus, existing between him and the State, of one of the kinds mentioned in the Article.

The AAR observed that a more liberal interpretation should be given to DTAA's based on the other circumstances, all the Articles in the treaty and the structure as well as the background in which the DTAA was entered into. The DTAA ought to be read as a whole. Article 4 of the treaty should not be narrowly construed. The applicant is admittedly liable to tax in India on his Indian Income though he is non-resident under the Indian tax laws. Hence, the applicant can claim the benefits of the DTAA under Article 1 of the DTAA as he was a resident of one of the Contracting States.

The AAR further observed that if the relevant criterion was only to be the person actually subject to tax, the Article would have used the words "a person who is subjected to tax in that state" or would have stopped with the words "liable to tax in that state under the laws of the state". The further words namely "by reason of his domicile" would be pure surplusage. Moreover several Articles in the DTAA concerning the individuals would make no sense at all if individuals living in UAE are treated as excluded from the benefit of the agreement because they are not currently subjected to tax in U.A.E. the AAR also noted that a large number of such provisions relating to individuals could not have been inserted in the agreement merely to meet a situation, which does not arise on the date of the DTAA but may arise in future (when tax is levied on individuals).

The AAR was also of the opinion that structure of the agreement was a clear pointer that the intention was to attract capital as with regard to items like dividends, interest and royalty (Articles 10-11-13) which were taxed in both the States the rates of tax was pegged low in the Source State so as to attract more capital. If individuals from UAE were excluded it made the DTAA devoid of all contemporary relevance. Hence, the interpretation which considers the treaty as a whole, all its Articles, and gives full meaning to all the words employed in Article 4(1) of the DTAA would be more appropriate which considers individuals living in UAE earning income there as resident of UAE, though at present not liable to tax but is certainly liable to be called upon to pay income tax under laws of that state.

Based on the above decision the AAR for the purpose of determining the residential status the AAR held that if the applicant is Resident of both the States, under the tie breaker tests, he was to be considered as resident of Dubai as his personal and economic relations are closer to Dubai rather than India. The applicant was, therefore, held to be entitled to the benefits of the DTAA with respect to Articles 10, 11 and 13 of the DTAA.

4. Cyril Eugene Pereira In re, 239 ITR 650 [1999] (AAR)

The applicant was an individual residing permanently in UAE and was a non-resident in India. During the previous year, i.e. 1997-98, the applicant's stay in India was for 112 days only. The applicant was a non-resident in India as during the four preceding financial years, his total stay in India was 175 days. The applicant claimed that he had a habitual abode in UAE due to his employment. The applicant's personal and economic interests were divided

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over two countries in as much as he had permanent home available in both the countries; his family consisting of wife and children resided in India and he in UAE on account of employment.

The applicant had salary income from his employer Abu Dhabi Gas Industries Limited and income in India in the form of interest, dividend and income from mutual funds approximated Rs.75, 000/-. In the light of above facts and submissions, the questions raised before the AAR were:

- (i) On the facts and circumstances of the case, and having regard to the fact that:
 - (a) the applicant's stay in India in the year is less than 182 days, and the stay in four preceding years is less than 365 days, hence, he is nonresident in India under Section 6 of the Act and
 - (b) he has a permanent home available to him in UAE as well as in India
 - (c) having regard to the fact that his 'Centre of Vital Interest' cannot be determined, but
 - (d) having regard to the fact that he has (due to his employment) his habitual abode in UAE whether the applicant would be regarded as a resident of UAE in terms c Article 4 of the DTAA entered into between India and UAE?
- (ii) On the facts and circumstances of the case, whether the applicant would be entitled to be taxed at the lower rate of tax as per Article 10 para 2(b) and Article 11 para 2(b) of the said Treaty:
 - (a) at the rate of 15percent on gross dividend income, arising in India (for dividend income prior to 1-6-1997) and
 - (b) at the rat of 12.5percent on gross interest income on investment accruing and arising in India to the applicant from the investments made in Debentures and Bonds of Indian companies or any other interest income on loans / advances made out of his moneys from his Non Resident External Accounts?
- (iii) Whether on the facts and circumstances of the case and having regard to the fact that the applicant is resident of UAE in terms of Article 4 of the said Treaty, gains arising on sale / transfer of his movable

properties would be taxable only in UAE and not in India as per Article 13 Para 3 of the said Treaty?

The applicant claimed relief under various provisions of the DTAA between India and United Arab Emirates for the reason that he was resident of UAE by virtue of his habitual abode in UAE. The applicant contended that the Central Government has entered into this Agreement with UAE with the full knowledge that there is no corresponding Income-tax law in force in respect of individuals residing in UAE. There is no reason to presume that the DTAA was entered into for the purpose of safeguarding the future contingencies of imposition of such laws in UAE. The DTAA must be implemented as it is, in consequence. The DTAA contained elaborate provisions in respect of 'persons carrying *on* independent personal services', 'dependent personal services', and other Articles, which are applicable to individuals only. Therefore, the applicant contended that the DTAA would apply equally to individuals and non-individuals.

The AAR's observations are summarized as:

- (i) As per Article 4 of the DTAA, 'resident' of a Contracting State means person who is liable to tax in the State by reason of his domicile, residence, place of management and place of incorporation, etc. The applicant is an individual and as such is not liable to pay any tax in UAE. Therefore, he could not be treated as a resident of UAE under Article 4(1) of the DTAA.
- (ii) The fiscal residence of a person had to be determined on the basis liability to pay tax and no other basis.
- (iii) In order to gain avail the benefits of the DTAA, the applicant must be able to say that he is liable to pay tax in both the countries and therefore, the DTAA must come into play for relieving the taxpayer from the burden of double taxation and not for absolving a taxpayer from the obligation to pay tax imposed by only on country.
- (iv) While interpreting section 90 and section 91 of the Act, the AAR observed that neither under section 90 nor under section 91 of the Act, any attempt has been made grant relief where there is no law in force in a foreign country levying tax on the same income, which is taxable under the Act.
- (v) The AAR observed that the second paragraph of Article 10 gave

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reduced rates of tax in the country of source for the dividend income, which has suffered the full rate of tax in the country of residence (of the recipient). Paragraph 2 pre-supposed that a tax is leviable under paragraph 1. Hence, wherever there is primary levy under paragraph 1, relief had to be given at the time of making the second levy under paragraph 2. However, in the instant case the applicant had not suffered any tax in UAE on dividend income (situation covered by paragraph 1) and therefore, he could not avail of the benefit of reduced rate of tax (situation covered by paragraph 2) under DTAA. The same observations would hold good in respect of Article dealing with interest income in India.

- (vi) While dealing with taxability of capital gains, the AAR observed that Article 13 of the Treaty (on capital gains) speaks of gains derived by a 'resident' of a Contracting State from immovable property situated in the other Contracting State. The applicant is not a resident of a UAE as he is not liable to pay any tax under the UAE laws and as such he cannot invoke protection of Article 13 of the DTAA in respect of his capital gains.
- (vii) Commenting on M.A. Rafik's case, the AAR observed that "one important point which was lost sight of in M.A. Rafik's case was the scope of Section 90 of the Act which confers upon the Government of India Jurisdiction to enter into an Agreement for the purpose of avoidance of double taxation only in a case where income of a person is taxable twice, i.e. under the Indian law as also under the corresponding law in force in a foreign country. If the income of a person is not taxable under foreign law, the Government of India is not empowered to enter into any Agreement for avoidance of double taxation respect of that income of that person".

The AAR further observed that a liberal interpretation, which does violence to the language of the agreement and makes it ultra vires Section 90 of the Act, should not be made.

Finally, commenting on the applicant's contention that various provisions of DTAA which are directed; towards individuals only, the AAR observed that these provisions will have a meaning only if and when the U.A.E. passes law imposing tax on individuals and notifies such law in the manner laid down in Article 3 of the Treaty. In that event it will not be necessary to enter into a

fresh agreement. Till such time, individuals do not come within the purview of the agreement at all.

The AAR therefore held that an individual who is not liable to pay tax under the UAE law cannot claim relief from the only tax on income which is payable in India under the agreement.

The provision of a DTAA does not apply to any case where the same income is not liable to be taxed twice under the existing laws of both the Contracting States. Accordingly, the AAR answered all the three questions in the negative and against the applicant.

5. Mr. Abdul Razak A. Meman; Mrs. Akila A. Meman and Mr. Mansih Bhatia, In re – A. A. R. No. 637/638/640 of 2004 dated 9 May 2005 [Unreported]

The applicants, citizens of India and non-resident individuals were working in the UAE. As the issues involved are similar the AAR has discussed the issues with reference to the first applicant who was working in the UAE since August, 1999. The applicant received dividend income from investments in shares of Indian companies and interest income on monies lying in various bank accounts. The applicant also intended to sell his shares, which would yield long/short term capital gains in India.

The applicant sought a ruling from the AAR on whether:

- (i) the applicant would be entitled to the benefits on the Double Tax Avoidance Agreement between India and UAE (DTAA);
- (ii) the applicant would be liable to capital gains tax in India on the transfer of shares considering the exemption provided in Articles 13(3) of the DTAA;
- (iii) the applicant would be entitled to the lower rates of tax prescribed for interest income in Article 11(2) of the DTAA.

With regard to the entitlement to the benefits of the DTAA:

The AAR observed that the term “person” as defined in the DTAA had a qualification that such person must be “treated as a taxable unit under the taxation laws in force in the Contracting States”. Therefore, to be treated, as a treaty subject the “person” had to be a “resident of one of the contracting States” which term was defined in Article 4 of the DTAA.

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The AAR held that “Resident of a Contracting State” means ‘any person who, under the law of that State, is liable to tax therein by reason of his domicile, residence, and place of management, place of incorporation or any other criterion of a similar nature. Thus the tax liability of a person in a Contracting State arises by reason of that person having a nexus with the Contracting State which may be any one of the criterion listed above that would entitle the Contracting State to levy tax on his global income. This nexus must be *in praesenti* and not at a future date.

The AAR further observed that once the nexus is established and that the net of the law of taxation of that State covers that person it is immaterial whether he actually pays tax or enjoys the benefit of exemption given by that State. In this connection the AAR has relied on the decision of the Supreme Court in the case of *UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)*. The AAR has also observed that in interpreting DTAA's regard should be given to the meaning of the terms as generally understood.

The AAR also rejected the Residence Certificate issued by the UAE revenue authorities on the ground that unlike in the case of Mauritius there was no Circular issued by the Central Board of Direct Taxes to provide that such a certificate would be adequate proof of residence under the DTAA.

Considering the importance of the issue and the conflicting decisions in the case of *Cyril Eugene Pereira, In re [1999] 239 ITR 650 (AAR)* and *Mohsinally Alimohammed Rafik, In re [1995] 213 ITR 317 (AAR)* and *Emirates Fertilizer Trading Company WLL, In re 272 ITR 84(AAR)* the AAR called for the records relating to the discussion between the Governments before finalizing the DTAA. The AAR observed that the record disclosed that the UAE Government was in the process of codifying tax laws for both individuals and corporates, however, for reasons unknown the codified tax law has not been enacted to date.

This further explained why the words “liable to tax therein” were incorporated in the definition of “resident” in the India-UAE DTAA but which are absent in DTAA's signed by the UAE with other countries like France, Germany and Canada. This further persuaded the AAR to believe that a resident of a contracting State would have to be a person who is liable to tax.

The AAR therefore, held that the applicant did not satisfy the requirements of a “resident of a Contracting State” as he was not liable to tax and was thus not entitled to the benefits of the DTAA.

The AAR has also observed that considering the speech of the then Finance Minister the intention of the parties was to extend the benefit of the DTAA to individuals also. However, as the anticipated codified tax law was not enacted the individuals were being denied the benefit of the DTAA. To give effect to the intention of the DTAA the AAR has suggested revisiting the DTAA by the Contracting States to modify if and as found suitable.

With regard to exemption from capital gains tax under Article 13(3) of the DTAA:

The AAR observed that Article 13(3) provided that capital gains from the alienation of property other than property stated in Paras 1 and 2 i.e., immovable property and movable property forming part of business property of a Permanent Establishment, would be taxable only in the State of residence. However, the AAR noted that as it had been held that the applicant was not a resident for the purpose of the DTAA and not a Treaty subject he could not claim benefit of the DTAA. The AAR differed with the decision of the AAR in the case of *Emirates Fertilizer Trading Company supra* as in that decision the AAR had held that the benefit of the treaty was applicable.

With regard to taxability of interest under Article 11(2) of the DTAA:

The AAR observed that para 1 of Article 11 gave the resident State the right to tax the interest income however, para 2 of Article 11 gave the source State the right to tax the interest income also at the rate specified therein if the recipient was the beneficial owner of the interest. The term used in para 1 was “resident”, as against “resident of a Contracting State”. Therefore, for the purpose of para 2 of this Article it would not be material whether UAE was levying tax on this income, as it was not a precondition of the para.

The AAR further observed that the term “resident” was not defined in the DTAA though the term “resident of a contracting State” was defined. As India was the State applying the DTAA; first the meaning under the Indian domestic law should be considered. However, even Section 6 of the Act defined “resident in India” and not “resident”. Therefore the term would have to be given its natural meaning. The AAR referred to definition in “The New Shorter Oxford English Dictionary (Edition 1993) and noted that the term “resident” meant, inter *alia*, residing, dwelling or having an abode in a place, staying regularly in or at a place for the performance of official duties or to work, study etc. The AAR observed that applicant who was residing in the

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UAE would fall within this definition and therefore would get the benefit of the rates specified in para 2 of Article 11. In this connection the AAR also relied on the Circular No. 734 dated 24th January, 1996 issued by the Central Board of Direct Taxes which clarified that the rates at which tax had to be deducted at source in respect of the payments made to non-resident Indian at the UAE which corresponded to the rates mentioned in Articles in the DTAA dealing with dividend, interest and royalties.

6. Linklaters LLP v. ITO [2010-TII-80-ITAT-MUM-INTL] (132 TTJ 20)

The taxpayer, was a UK-based limited liability partnership, engaged in law practice. It did not have a branch or any other similar form of presence in India, but rendered legal services to certain clients whose operations extended to India. These services were rendered partly from the UK and at times, by partners and staff visiting India. During the financial year under consideration, the taxpayer's partners/staff were present in India for more than 90 days.

The taxpayer disclosed 'nil' taxable income in Indian tax return by claiming treaty benefit and by contending that it has no PE presence (including service PE) in India.

Without prejudice, the taxpayer also claimed that as per DTAA, profits of PE were to be computed having regard to the market conditions in India. Arm's-length income of PE is based on fiction of independence and is required to be calculated having regard to the rates that would have been charged by Indian lawyers/professionals for similar services.

The Tax Department rejected the taxpayer's arguments and concluded that the taxpayer had a service PE in India. Entire income in relation to Indian projects (including services rendered from the UK office) was taxed on the ground that no details about overseas work was furnished.

On appeal, the CIT(A) agreed with the AO on the applicability of service PE Rule, but restricted taxation only to the extent of services rendered in India.

Treaty eligibility to the overseas firm assessed as flow through entity in home country:

The ITAT raised the issue about eligibility of the UK firm to claim treaty benefit. The issue was raised on account of 'reverse hybrid situation' and 'asymmetrical taxation' scenario arising from the UK firm being taxed in India at an entity level, whereas in the UK, the assessment is as a pass

through/transparent entity in the name of the members of the firm. The ITAT rejected primary contention of the taxpayer challenging right of the tribunal to consider the issue for the first time. The ITAT was convinced that the legal issue could be examined by it after providing reasonable opportunity of hearing to the parties if the tribunal finding did not enlarge the quantum of income as assessed by the lower authorities.

Having proceeded to answer the issue, the ITAT held:

- The UK legal firm is a person under the treaty definition of the term.
- The difference in taxation system applicable to the partnership firm in the source jurisdiction [(India) and residence country (UK)] results in economic double taxation though not juridical double taxation. The philosophy of DTAA which supports merits of avoiding juridical double taxation should equally be applicable to a situation of economic double taxation.
- The decision of Canadian Court in the case of TD securities (USA) LLC v. Her Majesty the Queen, (2010 TCC 186) supports that the treaty benefit can be given even in a situation involving asymmetrical taxation. In this case, single-member LLC of the USA was given the benefit of USA-Canada treaty despite the fact that in Canada, assessment was in the names of LLC whereas in the USA, due to the option exercised, the assessment was in the name of the member of the LLC. The decision also supports that the treaties need to be interpreted on a contextual basis rather than based on strict principles of interpretation as applicable to tax laws. The treaty interpretation is not subjected to literal interpretation in isolation with the objects and the purpose for which the treaty provisions are made.
- The treaty benefit is available to a person who is a treaty resident of the other country. In terms of the treaty, an entity is resident of the UK if it attracts tax liability in the UK on account of criteria such as domicile, residence, place of management. Though the modalities or mechanism of taxation may vary, facts of taxation need to be decided in an objective and uniform manner.
- In a situation where the entire income of a partnership firm is taxed in its own hands or in the hands of a partner, the definition of residence should be regarded as fulfilled. The Canadian decision in TD Security's case supports that the term 'liable to taxation' needs to be interpreted in a pragmatic manner so as to extend the treaty benefits

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to fiscally transparent entities. The test of fiscal domicile relevant for treaty residence purpose is fulfilled so long as the country of residence has right to tax income of the firm, irrespective of whether such right is actually exercised by the resident state or not.

- As a result, the taxability of entire income in the country of residence is more relevant rather than the mode of taxability i.e., whether the tax is levied in the hands of the firm or in the hands of the partners. The treaty benefit therefore cannot be denied to the firm so long as entire income of the firm is taxed in the residence country, not in its own right but in the hands of the partners.
- Incongruent result arising on account of asymmetrical result needs to be avoided and the benefit of the treaties is to be given so long as income of the enterprise is subjected to taxation in the other jurisdiction either directly or indirectly.
- The OECD report dealing with applicability of DTAA to partnership has indicated that in case of asymmetrical taxation, benefit should be available to the partners and not to the partnership firm. The ITAT consciously took the decision of adopting a view different from that by the OECD report which suggested grant of treaty benefit to the members of the firm. Reference was made by the ITAT to the reservation of India on the OECD commentary to conclude that the Government had rejected the stand of the OECD.

Other issues:

- The firm had a fictional service PE in view of presence of its partners/personnel in excess of the specified threshold.
- Actual revenues earned by taxpayer needs to be considered in respect of third-party dealings. It is not correct to apply hypothetical rates of earnings based on what could be the earnings of other Indian legal firms.
- The UK treaty provides for taxation of profits in the state to the extent they are directly or 'indirectly attributable' to that PE. The inclusion of profits indirectly attributable to the PE incorporates a force of attraction principle in the UK treaty.

This permits taxability of overseas income in respect of services rendered for an Indian project if it is similar or relatable to the services rendered by the PE.

7. Schellenberg Wittmer along with its partners [2012] 210 Taxman 319 (AAR)

The Applicant was a Switzerland based partnership firm (the firm) and its partners are tax residents of Switzerland. The firm is engaged in the practice of law in Switzerland and it does not carry out its activities in any other country. The Applicant was appointed by an Indian company for representation in an adjudication proceeding in Switzerland.

The question posed for consideration before the AAR was whether the firm could be treated as a resident of Switzerland under the India-Switzerland tax treaty and whether the legal fee received by the partnership firm from the Indian company would be taxable in India.

The AAR, based on the facts and arguments of the case, observed and held as follows:

- The definition of the term 'person' provided in the tax treaty includes, inter alia, a company, body of persons, or any other entity 'which is taxable under the laws in force in either contracting state'. The firm is not a 'person' under the tax treaty for the following reasons:
 - There is no definition of the term 'person' in Swiss Law corresponding to section 2(31) of the Act which confers the status of a 'person' on a partnership firm;
 - The partnership firm is not a taxable entity in Switzerland.
- Although the partners of the firm are residents of Switzerland, they cannot invoke the tax treaty to determine the taxability of the legal fees received by the firm since they have not received the legal fees from the Indian company;
- The source of income for rendering professional services to the Indian company is in India. The fact that the major part of the services are rendered outside India in respect of a dispute arising in India cannot alter the source of income;
- Accordingly, the firm will not be treated as a resident under the tax treaty and will not be entitled to treaty benefits. Therefore, the legal fees received by the firm will be taxable in India.

8. Abu Dhabi Commercial Bank Ltd. v. ADIT [2012] 138 ITD 83 (Mum)

The taxpayer, a banking company incorporated in United Arab Emirates

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(UAE) is having branches in India. The income from banking operations in India was offered for tax in India. In computing the total income, based on the provisions of Article 7(3) of the tax treaty (prior to 1 April 2008) the taxpayer was of the view that provisions of the Act relating to computation of business income which restricts the allowance of expenditure will not be applicable. Hence, the restrictions of Section 44C of the Act will not be applicable. The AO observed that the intention of Article 7 of the tax treaty is to ensure that the correct profit is brought to tax. The AO held that head office expenditure will be allowed only as per the limit prescribed under Section 44C of the Act. The CIT(A) upheld the finding of the AO.

Tribunal's ruling

- On a perusal of Article 7(3) of the tax treaty prior to 1 April 2008, in determining the profits of PE, there is no restriction on allowing of head office expenditure and other expenditure attributable to PE.
- In the present case, if any interpretation is given for retrospective operation of Article 7 of the tax treaty, it creates new obligation and disturbs the assessability of the profit of the PE. The retrospective operation cannot be taken to be intended unless by necessary implication it has been made to have the retrospective effect. Thus, the amendment brought in Article 7(3) of the tax treaty will not apply retrospectively.
- Article 25 of the tax treaty per se does not provide any rules on the mechanism for computing relief hence the domestic laws may have to be referred. Interpretation of Article 25 of the tax treaty that it extends to Article 7 of the tax treaty for applicability of domestic law will not be correct. If a computation of profit has been provided in a certain manner in Article 7 of the tax treaty, restrictions cannot be imported therein by virtue of Article 25 of the tax treaty.
- This amendment by way of protocol and Article 7(3) of the tax treaty has duly been considered by the Ahmedabad Tribunal in the case of Dalma Energy LLC¹¹⁵, where the applicability of Section 44C of the Act in Article 7(3) of the tax treaty for the earlier assessment years has been interpreted.
- Based on the above findings, the Tribunal has held that (i) the

¹¹⁵ ADIT v. Dalma Energy LLC [2012] 136 ITD 208 (Ahd)

limitation clause of applicability of the Act will not apply in Article 7(3) of the tax treaty and consequently, the provisions of Sections 44C of the Act will not be applicable, (ii) the amendment brought by way of protocol by which Article 7(3) of the tax treaty has been amended and limitation clause has been brought in, will not have any retrospective effect and (iii) the judgment of Mashreq Bank PSC is no longer relevant in view of the decision of the Mumbai Special Bench Tribunal in the case of Sumitomo Mitsui Banking Corp.

- Based on the above conclusions, disallowance of expenditure relating to head office cannot be made by invoking the provisions of Section 44C of the Act. Further, the income of the PE of the taxpayer shall be computed after allowing all the expenditure attributable to its business in India including the head office expenditure.

9. DIT v. Chiron Bearing Gmbh & Co. [2013] 351 ITR 115 (Bom)

The taxpayer is a foreign limited partnership and in its return of income for the AY 2002- 03, it claimed the benefit of Article 12(2) of the tax treaty in respect of royalties and FTS. On the basis of OECD Publication¹¹⁶, the AO held that the taxpayer is not eligible to claim the benefit of the tax treaty since it is not liable to tax in Germany being a limited partnership. The CIT(A) held that the taxpayer was paying trade tax in Germany which is a tax paid on profit of the business and it is covered by Article 2 of the tax treaty. The CIT(A) also relied on TRC issued by the German authorities. Accordingly, the CIT(A) held that the taxpayer is entitled claim the benefit of lower rate of tax in respect of royalties and FTS. The Tribunal upheld the finding of the CIT(A).

High Court's ruling

- As per Article 12 of the tax treaty, royalty and FTS received in India by a person resident outside India are not liable to tax in India in excess of 10 percent of the gross amount received. On examination of the tax treaty, it is clear that in terms of Article 2(3) of the tax treaty, the trade tax paid in Germany is one of the taxes to which tax treaty applies.
- Further, as per Article 3(d) of the tax treaty, 'person' includes any entity treated as a taxable unit in Germany. The term 'resident' in terms of Article 4 of the tax treaty means 'any person who, under the

¹¹⁶ The Application of the OECD Mode Tax Convention to Partnership

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laws of Germany is liable to tax therein by reason of his domicile, residence, place of management or any criterion of a similar nature'.

- The CIT(A) and the Tribunal has on examination of records found that taxpayer is filing trade tax return in Germany and therefore is paying tax to which the tax treaty applies. Further, the TRC issued by German authorities indicates that the taxpayer is considered as a taxable unit under the taxation laws of Germany. Therefore, the tax treaty is applicable to the taxpayer and the benefit of Article 12(2) of the tax treaty cannot be denied.
- There is no merit in the submission of the tax department that the taxpayer cannot be considered as a taxable entity in view of the OECD commentary. Accordingly, the entire issue is governed by the tax treaty and on the basis of evidence laid before the authorities. Therefore, the taxpayer is eligible for the benefit of lower tax rate on royalty and FTS earned in India as per the tax treaty.

Dependent/ Independent Personal Services and Other Articles

1. Ensko Maritime Ltd. v. Deputy Commissioner of Income tax [2004] 91 ITD 459 (Del)

The taxpayer, a foreign company was engaged in the business of off-shore drilling. The foreign company had entered into a contract with ONGC for performance of drilling operations on off shore rigs, for which, it deputed its technicians to India.

The foreign company filed tax returns on behalf of the technicians claiming that the salary income was not liable to tax in India under Article 16 of the DTAA between India and U.S.A. (short stay exemption) as the following conditions specified therein had been satisfied –

- (i) the technician was present in India for less than 183 days
- (ii) remuneration was paid by an employer who was not a resident of India
- (iii) the remuneration was not borne by a PE of the employer in India.

The AO rejected the claim of the technicians on the ground that the employer foreign company had a PE in India whose income was assessed on 'deemed' basis under Section 44BB of the Act. Therefore, the remuneration had been deducted in computing the profits of the PE in India. The third condition mentioned above was thus not satisfied whereas to claim the advantage of

the DTAA all three conditions ought to have been cumulatively satisfied. The CIT(A) upheld the AO's order.

The foreign company filed an appeal to the Delhi Tribunal. The foreign company contended before the Tribunal that one of its employees would be governed by the DTAA with Australia and the others by DTAA with Indonesia.

The Tribunal held that the employer rendered the services to the PE and expenses were relatable to the PE. These expenses were deemed to be allowed in computing the income under Section 44BB of the Act and therefore the benefit of the DTAA could not be allowed.

The Tribunal observed that the AO had assessed the foreign company as well as the employees as non-residents and therefore the first two conditions were satisfied. The only issue to be considered was whether the third condition had been satisfied.

The Tribunal observed that it was undisputable that the foreign company had a PE in India whose profits were taxable in India. The Tribunal observed that the following features were essential for a PE; the activity must be exercised in an independent manner; it must consist of repetition of well-defined actions and it must have economic character. These features come out of Article 5 which defines PE and which has to be read along with Article 7, which defines business profits.

Further, as per Article 7 the profits are to be computed at arm's length after deducting the expenses, which have a direct nexus with the PE. The Tribunal held that the salary expenses had a direct nexus with the PE and therefore were deductible as business expenditure for computing the taxable profits irrespective of whether the salary was actually paid in India or abroad.

The Tribunal observed that Section 44BB of the Act was only a computation section and did not derogate from the provisions of the DTAA. The word "borne" refers to a liability, which a person is liable to discharge or the actual sum paid. Therefore, in computing the profits under section 44BB at a deemed rate all the expenses directly relatable to the PE were deemed to be allowed.

The Tribunal therefore held that the third condition was not satisfied and hence the foreign technicians were not eligible for benefit under the DTAA's with U.S.A., Australia or Indonesia.

2. CIT v. Halliburton Offshore Services Inc [2004] 140 Taxman 405 (Uttanchal)

A foreign company had executed contracts in India. The foreign company entered into a contract with the taxpayer, a foreign technician employing him for working on rigs in India. The contract between the foreign company and the foreign technician provided for “on period” and “off period” referring to alternate time schedule. The salary was paid for both the periods. An “Off period” followed on period and during the “off period” the foreign technician was physically present outside India. The foreign technician derived salary from the foreign company and claimed that salary paid to him for the “off period” outside India was not taxable in India because the “off period” following the “on period” was not a rest period.

The Tribunal upheld the contention of the foreign technician. The tax authorities then preferred an appeal to the Uttanchal High Court. The High Court held that the salary paid to the foreign technician for the “off period” outside India was taxable in India.

The High Court observed that Section 9(1)(ii) of the Act *inter alia* laid down that the salary income would be deemed to accrue in India if it was earned in India. So, if the services under the contract for employment were rendered in India, the place of receipt/actual accrual of salary was immaterial. It thus held that Section 9(1)(ii) read with the Explanation thereto, provided for an artificial place of accrual for the salary income.

The High Court observed that the intention of the contracting parties could be ascertained by studying the terms and conditions of the contract and in certain appropriate cases the surrounding circumstances of a contract including the conduct of the parties. Based on such a study, in the instant case, it observed that the “off period” and the “on period” formed an integral part of the contract so it was not possible to give separate tax treatment to the salaries of the “off period” and the “on period”.

The High Court held that even if the off period was a standby arrangement and not a rest period, then too the salary received for the off period would be for the services rendered in India and was taxable in India, since working on oil rigs being hazardous, the foreign technician had to undergo demonstration/training in the off period to remain fit mentally/physically and thus the demonstration/training outside India had a direct nexus with the services the foreign technician had to render on oil rigs in India.

The High Court noted that the salary to the foreign technician for both the off period and the on period was paid by the foreign company from its income of its Indian operations which clearly showed the intention of the contracting parties and thus, the entire salary of the foreign technician for both the “off period” and the “on period” was taxable in India.

3. Maharashtra State Electricity Board v. DCIT [2004] 270 ITR 36 (Mum)

The taxpayer, a company, intended to enter into a power purchasing agreement with ENRON. The company engaged the services of U.K. based firm of solicitors to assist them in the negotiations for finalization of the agreement with ENRON. As per the terms of the agreement entered into with the firm on 21st June, 1993 the firm was also to advise them on legal implications of the commercial and financial arrangements entered into and review the state of discussions/correspondence between the parties.

The professional fees for the services were to be worked out at an hourly rate plus reimbursement of costs. The total fees inclusive of reimbursement were capped at GBP 900,000. The company sought the AO's permission to remit the money in settlement of the bills. Before the AO the Company took the stand that the payments were covered under Article 15 of the Agreement for Avoidance of Double Taxation between India and U.K. (DTAA)¹¹⁷ dealing with “Departmental Personal Services” and that as none of the partners of the firm had been in India for more than 90 days the payment for the legal fees were not eligible to tax in India.

The AO was of the view that Article 15 was only applicable when the services are rendered by an individual and not when services are rendered by a firm. The AO further held that in any event the benefit of Article 15 could not be availed, as the total man-days spent in India were more than 90 days. The AO computed the man-days considering the time spent by each person of the firm as against solar days¹¹⁸. The AO therefore held the fees to be in the

¹¹⁷ Please note that the DTAA dealt with here is the old India – U.K. DTAA. The Tribunal has also noted that the provisions of the old DTAA, which used the words “resident of a Contracting State”, were broader than the provisions of the new DTAA, which use the words “individual..... who is a resident of a Contracting State”. The new DTAA also specifically excludes U.K. partnerships from the definition of “person” and therefore the ratio of this decision may not apply in the context of the new DTAA.

¹¹⁸ As per the AO man-days referred to in the DTAA meant that if a person spent a day

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nature of fees for technical services per Article 13 of the DTAA. The AO thus directed the company to deduct tax on multiple grossing up basis as the tax was to be borne by the company.

The CIT(A) agreed with the view of the AO that Article 15 would apply when services are rendered by an individual. The CIT(A) also held the service rendered by the firm to be a technical as well as a consultancy service. For counting presence in India, however he did not agree with the AO and observed that it would be logical to assume presence going by solar days and not man- days. The company preferred an appeal to the Mumbai Tribunal.

The Tribunal held that the services rendered were professional services falling under Article 15 of the DTAA and in the absence of a fixed base and considering that the cumulative stay did not exceed 90 days the legal consultancy fees would be taxable in the hands of the U.K. solicitor firm only in the U.K. and therefore the Company was not under an obligation to deduct tax at source.

In arriving at its conclusion, the Tribunal considered the provisions of Article 4-“Fiscal Domicile”, Article 13-“Royalties and Fees for Technical Services” and Article 15-“Departmental Personal Services” and Article 15-“Independent Personal Services” of the new DTAA with U.K.

The Tribunal adopted a two-pronged approach in its analysis, first whether Article 15 applied to persons other than individuals and secondly whether the services rendered were in the nature of professional services.

As regards whether Article 15 applies to persons other than individuals such as firms the Tribunal observed that the wordings of Article 4(3) of the DTAA “a person other than an individual...” left no doubt that the expression “resident of a Contracting State” is not confined to individual residents but extends its scope to non-individuals such as firms, companies and other entities since the question of “place of effective management” can only arise in the case of these entities. Therefore, Article 15, which uses the word

in India it will be counted as one man-day and if five people spent one day in India it would be counted as five man-days. The Company's contention was that only solar days had to be considered i.e. if five people spent one day in India it had to be counted as one man-day only.

“resident”, would apply to individuals as well as other entities. The Tribunal held that exclusion cannot be inferred and therefore the tax authorities were not correct in inferring that firms were excluded in Article 15 of the DTAA.

As regards whether the services rendered could be considered as professional services the Tribunal observed that a “professional service” would mean any service rendered in the course of a vocation carried on by an individual or a group of individuals requiring predominantly intellectual skills dependant on individual characteristics and specialized education or expertise. Therefore, it was beyond doubt that the service rendered was a professional service. The natural corollary to these answers would be that the service would fall under Article 15 of the DTAA.

As regard the issue of whether multiple counting of common days where more than one person from the solicitors firm was present is permissible i.e. whether solar days are required to be taken or man-days the Tribunal relying on the decision of the Mumbai Tribunal in the case of *Clifford Chance, United Kingdom v. Deputy CIT* [2002] 82 ITD 106 observed that multiple counting would lead to absurdity and would defeat the purpose of Article 15 of the DTAA which is to provide for substantial and permanent presence as opposed to transient and fleeting presence in the Contracting State.

In view of the above, the Tribunal observed that the taxability of the income would have to be examined under Article 15 and as the CIT(A) had given a clear finding that the number of days had not exceeded 90 days the income would not be taxable in India.

The Tribunal also dismissed the tax authorities contention that the fees would fall under Article 13 on the ground that a special Article for professional services would override the general provisions of Article 13 which apply to broader category of “managerial technical or consultancy services”. In arriving at this conclusion the Tribunal relied on the decision of the Bombay Tribunal in the case of *R.P.G. Industries Ltd. v. Asst. CIT* [2003]85 ITD 105 and the decision of the Calcutta Tribunal in the case of *CIT (Asst.) v. Executors of the Estate of Bhagwan Devi Sarogi* [2001] 79 ITD 539.

The Tribunal has also discussed the decision of the Supreme Court in the case of *Transmission Corporation of Andhra Pradesh Ltd. v. CIT* [1999] 239 ITR 587 and held that the facts not being *pari materia* the decision would have no bearing on the case in hand. The Supreme Court therein was dealing with an issue where the income was not fully exempt, in that case

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only is a taxpayer duty bound to approach the tax authorities. If the income is not chargeable to tax there is no obligation to approach the tax authorities. The Tribunal noted that as it had already given a finding that the payment was not liable to tax in India neither the provisions of Section 195(2) nor the decision of the Supreme Court had any bearing on the case.

Tribunal also dismissed the tax authorities' suggestion that the Company's interest was not prejudiced by paying tax as the non-resident could claim a refund by stating that it would be contrary to the scheme of the Act to call upon the Company to deduct more tax than it was duty bound to.

The Tribunal therefore held that as the income was not taxable in India per Article 15 of the DTAA the Company was under no obligation to deduct tax on the payments made to the U.K. based firm of solicitors.

4. Graphite India Ltd. V. DCIT [2003] 86 ITD 384 (Kol.)

The taxpayer, a company engaged in the business of manufacturing of graphite electrodes, anodes, etc. appointed an individual, resident of the United States of America (USA) as a consultant on retainer basis for improvement and upgradation of the Company's products. The Consultant was a scientist by profession and in regular employment as Director of Carbon Research Centre, USA.

The Company moved an application to the AO for remittance of the consultancy fees without deduction of tax at source as the payments were covered under Article 15 –Independent Personal Services, of the DTAA between India and USA and the conditions stipulated therein for taxability were not satisfied.

The AO rejecting the claim directed the company to deduct tax at source on the fees considering the same as Fees for Included Services covered under Article 12(4) of the DTAA. The CIT(A) dismissed the Company's appeal. On further appeal, the Tribunal held that

- the services rendered by the consultant were held to be in the nature of professional services as referred to in Article 15, as the work involved, predominantly, intellectual (rather than manual) skills dependent on individual characteristics and presupposed the individual's specialised and advanced education or expertise in related fields. The Tribunal referred to the definition of the term 'professional services' in the Law Lexicon edited by Justice Y.V. Chandrachud (1997 Edition) and the Black's Law Dictionary (5th edition)

- the provisions of Article 12(4) and Article 15 are non-competing and mutually exclusive. Therefore, as a corollary and in view of the specific provisions of Article 12(5), the fees paid were outside the scope of Article 12(4)- Fees for Included Services.
- the connotations of 'fixed base' for the purpose of Article 15 were akin to a professional's chamber which, in broad terms implies a place from where the person could conduct his independent professional services
- The 'entire factory premises and auxiliary space' could only be for the purpose of carrying out the specific assignment in connection with which he might have visited the factory, but that could not be equated to a place 'regularly available' to him from which he carried out his independent professional activities.
- the ninety day stay condition was also not fulfilled and accordingly the payment was also not chargeable to income-tax in India by virtue of Article 15 of the DTAA

5. ACIT v. Ellis 'D' Rozario (I.T.A No. 2918/Del/05)

ABC, a Company headquartered in Dubai, posted its employee ("expatriate"), an Australian national, to the Liaison office in New Delhi, India, as the Regional Manager, Indian Sub-Continent.

As per the employment contract between the expatriate and the Company, the expatriate besides rendering services in India for its Indian operations was also required to perform such duties as may be directed by the Company from time to time including business travel outside India for its regional operations.

The residential status of the expatriate in India was 'Resident but Not Ordinarily Resident' for the relevant tax year 2000-01.

The expatriate offered his salary to tax on a proportionate basis for 224 days for the services rendered in India and did not consider the salary for 51 days while he was rendering services outside India.

Issue before the Tribunal

Whether the salary earned by the expatriate for the services rendered outside India was to be considered taxable in India?

The expatriate contended that the services rendered outside India for 51

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days were unrelated to the Indian operations / activities and accordingly, the salary pertaining to the said period was not taxable in India.

Tribunal's Ruling

The Tribunal held that in earlier judicial precedents¹¹⁹ relied by the tax payer, the contract of employment specifically provided the individual to work outside India for a particular period of time.

In the instant case, it was agreed between the Company and the expatriate that he could be asked to perform such duties as may be directed by the Company including business travel outside India. However, the specific time period for rendering services outside India was not mentioned in the employment contract.

The Tribunal observed that to the extent the expatriate is able to substantiate that he has not performed any activity in relation to the Indian operations while working outside India, the proportionate salary for the days outside India would not be taxable in India.

In the instant case, the expatriate had not submitted any documentary evidence in respect of work done outside India for regional operations. Therefore, the Tribunal has restored the matter to the tax authorities for determining the same.

6. ACIT v. Monitor India Pvt. Ltd [2010-TII-138-ITAT-MUM-INTL]

The taxpayer is a company engaged in the management, technical advisory and consultancy services. The taxpayer made payments of professional fees to its group companies were companies outside India. On the basis of legal opinion, the taxpayer did not deduct any taxes from the remittance of the professional fees.

The AO disallowed the claim for professional fees under Section 40(a)(i) of the Act. Further he contended that payment of professional fees should not be allowed as a deduction since withholding tax has not been made. Also,

¹¹⁹ WA Kielmann (ITR No. 4/ 1979) dated 9th August, 1984 – Delhi High Court, J. CALLO AND OTHERS in ITA 5921 – 5926 / Del / 86 dated 2 August 1989 – Delhi Tribunal, Eric Moroux in ITA No. 1174 / Del / 2005 dated 15 Feb 2008

the taxpayer ought to have approached the AO with an application under Section 195(2) of the Act, seeking permission to remit the monies without deduction of tax.

On appeal, Tribunal held that the consultants of the Group Companies did not stay in India for a period exceeding number of minimum days prescribed in Article 5 of the respective tax treaties and accordingly did not have a permanent establishment in India. Accordingly, no income is accrued to the non-resident companies in India and the taxpayer was not required to deduct tax at source.

The Tribunal relied on the decision of the Supreme Court in the case of GE India Technology Centre Private Ltd wherein it was held that:

Section 195(2) of the Act gets attracted only where the payment made is a composite payment in which a certain proportion of payment has an element of income chargeable to tax. If the payment has no element of income chargeable to tax in India, then the taxpayer is under no obligation to approach the AO seeking permission to effect the payment without deduction of tax.

Relying on the Supreme Court decision in the case of *GE India Technology Centre Private Ltd.* the Tribunal held that the taxpayer was under no obligation to approach the AO under Section 195(2) of the Act. Further the taxpayer was entitled to effect the remittances without deduction of tax at source if it was of the opinion that the remittance was wholly exempt from Indian taxes.

7. IDS Software Solutions India (P) Ltd. v. ITO [2009] 122 TTJ 410 (Bang)

ABC, India, an Indian Company is a 100percent subsidiary of a foreign Company ABC, US and is engaged in the business of software development. ABC, India had entered into a “secondment agreement” with ABC US for securing services of personnel for its business. Pursuant to the said agreement, an expatriate was seconded to ABC India and was appointed as the Managing Director of ABC India. As per the terms of the agreement, the expatriate was to act in accordance with instructions, directions and supervision of ABC India. The expatriate was to report to the board of ABC India and was required to devote the whole of his time, attention and skills to the duties required by ABC India.

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ABC India was required to reimburse ABC US for the compensation paid to the expatriate which inter-alia included salary, bonus and other expenses paid by ABC US without any mark up.

Issues before the Tribunal

Whether the payment by ABC India to ABC US, was to be considered as a mere reimbursement of salary of the expatriate or as a “Fee for technical services” and subject to withholding tax?

The Tribunal Ruling

- It would be necessary to see whether the director was appointed under the Articles of Association of the Company and whether in addition to the Articles, there was an independent or special contract between the Company and the director, in which case alone it can be said that the director was an employee of the Company.
- In the instant case, the secondment agreement constitutes an independent contract of service in respect of the employment of the expatriate with ABC India. The special contract need not be between ABC India and the expatriate, so long as the relationship between them is defined in a contract and the contract is between connected and relevant parties.
- As the expatriate has been seconded to ABC India, rendering services subject to the supervision and control of ABC India and that the salary cost is also borne by ABC India, therefore, ABC India should be considered as the ‘economic employer’ of the expatriate.
- As the expatriate was an employee of ABC India and taxes had been withheld and deposited with the Indian tax authorities on his salary income, ABC India was not liable to withhold tax on the reimbursement of the salary to ABC US.

The Tribunal held that the secondment agreement cannot be construed as an agreement for ‘fee for technical services’.

8. Cholamandalam MS General Insurance Co. Ltd. [2009] 309 ITR 356 (AAR)

XYZ, an Indian Company is engaged in the business of non-life insurance. It is interested in expanding its business in India, for which it requires a person who has the requisite knowledge and experience. The Indian Company

entered into a “secondment agreement” with an Overseas Company for securing the services of personnel of the Overseas Company. Pursuant to the said agreement, an expatriate was seconded to the Indian Company. The expatriate was to work under the direction, control and supervision of the Indian Company.

During the secondment, the Overseas Company continued to pay salary and other benefits to the expatriate. Further, the Overseas Company withheld and deposited tax on the expatriate’s salary with the Indian tax authorities. The Indian Company was required to reimburse part of the salary and other benefits of the expatriate to the Overseas Company.

Issue before the AAR

- Whether reimbursement of the part salary by the Indian Company to the Overseas Company constitutes an income of the Overseas Company and hence, subject to withholding tax?
- Whether the Overseas Company has a Permanent Establishment (“PE”) in India?

The Indian Company contended that the payment to the Overseas Company was in the nature of reimbursement of the salary and the same cannot be considered as an income of the Overseas Company in India. Therefore, no taxes should be withheld on the said reimbursement. Further, it was contended that the Overseas Company has no PE in India.

Decision of the AAR

- It is essential to see the real nature of the payment and the essence of the transaction to determine whether the payment made by the Indian Company to the Overseas Company can be considered as FTS or not.
- In the instant case, the Overseas Company itself does not provide any managerial, technical or consultancy services to the Indian Company. Further, it has not seconded the expatriate to carry out such services on its behalf.
- Even though the Overseas Company provided the services of a technically qualified personnel, it cannot be said that the payments made by the Indian Company to the Overseas Company should be treated as FTS.

The AAR held that the secondment agreement was a mutually beneficial arrangement between the Indian Company and Overseas Company and a

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FTS arrangement was never contemplated. It was also held that the payment made by the Indian company to the overseas company was a mere reimbursement of salary and no income arose to the overseas company. Consequently, the Indian company was not required to withhold tax on such payment. The AAR did not take up the PE issue.

10. CIT v Eli Lilly and Co. India (P) Ltd [2009] 312 ITR 125 (SC)

XYZ, a company incorporated in India is engaged in the business of manufacturing and selling pharmaceutical products in India. Its foreign affiliate seconded few expatriates to the Indian Company. The expatriates rendered services in India for the Indian Company and no work was performed for the Foreign Company. The expatriates were paid part salary by the Foreign Company outside India ("overseas salary") and part salary was paid by the Indian Company in India. The Indian Company deducted tax at source (TDS) on the part salary paid to the expatriates in India. However, no tax was deducted on the overseas salary of the expatriates. The tax on the overseas salary was paid by the expatriates as advance tax / self-assessment tax.

Issues before the Supreme Court

Whether TDS provisions are applicable on the payment of overseas salary to the expatriates by the Foreign Company in respect of the services rendered in India?

The Indian Company contended that each employer should deduct tax only on the salary paid by it, unless the employee declares the salary of one employer to other employer. The employer is not under an obligation to deduct tax on the salary paid by any other person even if such salary has a nexus with the services rendered by the employee with that employer. In the instant case, the overseas salary was not paid on behalf of or on account of the Indian Company. Therefore, the Indian Company is not liable to deduct tax on the overseas salary.

The Supreme Court decision

Applicability of TDS provisions

The salary paid by the Foreign Company is for the services rendered by the expatriates in India and no work was performed for the Foreign Company. Therefore, the Indian Company was liable to deduct tax on the overseas salary.

Interest for shortfall in deduction of tax

The interest in respect of shortfall in deduction of tax can be levied for the period starting from the date when tax was liable to be deducted till the actual payment of tax. Further, for the said purpose, the date of payment of tax by the employer can be treated as the date of actual payment of tax.

Penalty for default in deduction of tax

The penalty under Section 271C of the Act should not be levied as the Indian Company had reasonable cause for non-deducting the tax on the overseas salary on account of the following:

- The non-deduction of tax at source took place on account of controversial addition and concept of aggregation of income (i.e. Indian salary and overseas salary both are subject to tax) was a nascent issue.

The genuine and bona fide belief of the Indian Company for not deducting tax on the overseas salary substantiated by the fact that:

- The Indian Company has not claimed a corporate tax deduction of the salary paid by the foreign company; and
- The expatriate had paid advance/ self-assessment tax on the overseas salary.

11. DCIT v. Andaman Sea Food Pvt Ltd [2012] 52 SOT 562 (Kol)

The taxpayer is an Indian company engaged in the business of trading and export of sea foods. During the year under consideration, it had carried out huge volume of currency derivative transactions. In terms of the agreement with a Singapore based company, the taxpayer was required to pay consultancy charges at a specified percentage of the total transacted volume of forex derivatives, futures and options. The taxpayer was of the view that since the services were rendered outside India, the amount paid for consultancy services cannot be taxable as FTS under Section 9(1)(vii) of the Income-tax Act, 1961 (the Act). Accordingly, the taxpayer made payments to the foreign company without withholding of tax. However, the AO held that amounts paid to the foreign company were taxable in India as FTS as the services were used in India. Since the taxpayer failed to discharge his tax withholding obligation under Section 195 of the Act, the entire amount was disallowed under Section 40(a)(i) of the Act.

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The CIT(A) held that the consultancy fees paid to the foreign company is not covered by the scope of FTS under the tax treaty. Further the foreign company did not have a PE in India. Therefore, in the light of Supreme Court decision in the case of GE Technology Centre Pvt Ltd¹, the taxpayer did not have any tax withholding obligation in India. Accordingly, the CIT(A) deleted the disallowance.

Tribunal's ruling

- A tax treaty assigns taxing rights of various types of income to the source state upon fulfillment of conditions laid down in respective clauses of the tax treaty. When a tax treaty does not assign taxability rights of a particular kind of income to the source state under the tax treaty provision dealing with that particular kind of income, such taxability cannot also be invoked under the residuary provisions of Article 23 of the tax treaty either. The interpretation canvassed by the tax department, if accepted, will render allocation of taxing rights under a tax treaty redundant.
- Article 23 of the tax treaty begins with the words 'items of income not expressly covered' by provisions of the foregoing Articles (i.e. Articles 6 to 22) of the tax treaty. Article 23 of the tax treaty does not apply to items of income which can be classified under Articles 6 to 22 of the tax treaty whether or not taxable under these Articles. Accordingly, the income from consultancy services, which cannot be taxed under Article 7, 12 or 14 of the tax treaty because conditions laid down therein are not satisfied, cannot be taxed under Article 23 of the tax treaty either.
- When a recipient of an income does not have the primary tax liability in respect of an income, the payer cannot have vicarious tax withholding liability either. Accordingly, the taxpayer is not liable to withhold tax under Section 195 of the Act.

Deduction of Tax at source on payments to non-residents

1. ITO v. Prasad Production Ld. [2010] 129 TTJ 641 (Chen)(SB)

The Taxpayer was awarded a contract by the Tourism Department of the Government of Andhra Pradesh to establish IMAX Theatre at Hyderabad. The Taxpayer entered into an agreement with a Canadian company for

purchase of equipment, maintenance and installation. During the year under consideration, the taxpayer remitted payments to the Canadian company without deducting tax at source.

The AO observed that the payment made by the Taxpayer were for the provision of a variety of services to be provided by the personnel of the Canadian company which included installation charges, testing and training for projectionists. Therefore, according to him the amount remitted by the taxpayer was for provision of technical services by IMAX which falls under section 9(1)(vii) of the Act.

The AO after relying on the Supreme Court decision in *Transmission Corporation of AP Ltd.* held that since the taxpayer did not obtain any order under Section 195(2) or 195(3) or 197 of the Act, the taxpayer was liable to deduct tax under Section 195 of the Act. Accordingly, the AO initiated proceedings against taxpayer under Section 201(1) and 201(1A) of the Act.

On appeal, The CIT(A) held that since the sum paid represents part of the sale consideration for the equipment, they were not chargeable to tax in India. Further, the decision in the case of Transmission Corporation was not applicable when the entire sum not chargeable to tax. Accordingly, the order passed by the AO under Section 201(1) and 201(1A) of the Act was cancelled.

The department preferred an appeal against the said order of the CIT(A). A Special Bench ('SB') was constituted to hear the issue. The Tax Department relied on the various decisions of the Supreme Court to contend that the deduction of tax is tentative only and is subject to the assessment in the case of the deductee. According to the Tax Department, the payer has no discretion to determine whether a sum payable to non-residents is chargeable to tax or not else section 195 of the Act will become totally inoperative. Further, for no withholding or withholding at lower rate, a taxpayer will need to compulsory approach the Tax Authorities under Section 195(2) / (3) or Section 197 of the Act.

The Department also argued that the SB is bound to follow aforesaid principles promulgated by the Karnataka High Court in Samsung Electronics Co Ltd pursuant to Article 141 of the Constitution of India being a decision of superior judicial authority.

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Key contentions of Taxpayer and Interveners

- i. Taxpayer referred to section 4 and Section 5 of the Act and argued that the tax is required to be deducted from payments to nonresidents only if the income was chargeable to tax under the provisions of the Act read with an applicable DTAA.
- ii. Therefore, the Tax Authorities cannot proceed on a notional basis against the deductor. Reliance was placed on the Supreme Court decision in Eily Lily, Vijay Ship Breaking and plethora of other judicial precedents to support this view.

The decision of the Supreme Court in Transmission Corporation merely dealt with tax deduction with respect to income chargeable to tax. The Supreme Court never went into deduction on gross amounts or consequences of non-deduction. To that extent, the Karnataka High Court has misinterpreted the decision of the Supreme Court in the case of Transmission Corporation.

The SB observed the following:

- 1 The expression under Section 195 of the Act is “any other sum chargeable under the provisions of this Act”. This expression has been explained by the Supreme Court in the case of Transmission Corporation to mean even sums which are hidden or otherwise embedded therein.
- 2 But if Transmission Corporation’s decision is to be properly construed and understood, it would mean that the person making payment to the non- resident would be liable to deduct tax only when the payment so made is chargeable to tax under the Act which has been clarified by the Supreme Court in the case of Eli Lilly & Co also.
- 3 The Transmission Corporation applies only in two situations viz. where the entire payment has an income character and when part of the payment has an income character.
- 4 There is no basis to contend that the payer cannot determine the tax liability of payee with respect to the payments he is making to the payee.
- 5 Under Section 195(2) of the Act, the payer applies to the AO for deduction of tax at lower rate whereas under Section 195(3) of the Act the payee makes an application to the AO to receive the payment

without any deduction of tax. The reason for such difference is that when the payer has a bonafide belief that no part of the payment bears income character, section 195(1) of the Act itself would be inapplicable and hence the payer need not approach AO under Section 195(2) of the Act for nil deduction certificate.

- 6 The SB referred to the CBDT *Circular no. 759* and observed that tax has to be deducted at source by the payer only when he is paying to non- resident any sum which is chargeable to tax. Further, the said procedure was to comply with the provisions of the Reserve Bank of India manual and not of the Income-tax Statute.

Applicability of Karnataka High Court decision in the case of Samsung Electronics

1. The SB observed that there are other earlier decisions of the Karnataka High Court which are contrary to the decision in the case of Samsung Electronics. Particularly, in the case of *Jindal Thermal Power Co. Ltd.* The Karnataka High Court after referring Transmission Corporation decision stated that the Transmission Corporation decision does not lay down that the person who is obliged to withhold taxes has no right to question the assessment of tax liability.
 2. The conjoint reading of the Sections 195 and 201 of the Act makes it clear that the payer has every right to question the tax liability of the payee to avoid the vicarious consequences.
 3. The alternative CA procedure seems to have not been brought to the attention of the Karnataka HC in Samsung case. The Bench further observed that in cases where there are various high court decisions then the Tribunal can follow a view which appeals to it the most based on its own examination and explanation of the issue in light of the judicial decisions and taking guidance from them with respect and humility.
 4. Therefore, the payment made which is a part of equipment price including services of installation and training was not chargeable to tax in India. Accordingly, the taxpayer was justified in not withholding tax on such payments.
2. **GE India Technology Centre Private Limited v. CIT [2010] 327 ITR 456 (SC)**

The tax department had filed appeals before the Karnataka High Court

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contesting the decision of the Tribunal, allowing the appeal of several software companies (the taxpayers) in different cases.

The issue before the Karnataka High Court (HC) was whether the payments made by the taxpayers to non-resident suppliers for purchase of readymade shrink wrapped software packages constituted royalty.

The taxpayers, without obtaining a dispensation under Section 195(2) of the Act for NIL withholding, proceeded to make the remittances to the non-residents without deducting tax, on the premise that such payments did not constitute income chargeable to tax in India.

The Karnataka HC dismissed the appeals of the taxpayers¹²⁰ and observed that the taxpayers were obligated to withhold taxes on any payment made to non-residents which prima facie bears the character of income.

The HC did not deal with an issue - whether the payments made to the suppliers was in the nature of royalty. The Karnataka HC relied on the decision of the Supreme Court in the case of Transmission Corporation and made the following observations:

The mandate of deduction of tax at source under Section 195 of the Act has to be strictly followed by the payers.

- It is not for the payer to decide whether the payment made to a non-resident would constitute income chargeable to tax in India. Such a question needs to be answered by the AO.
- The payer can be relieved from the withholding obligation only by obtaining a dispensation for NIL withholding under Section 195(2) of the Act.

Appeals were then filed with the Supreme Court (SC) Observations of the Supreme Court

Tax deduction pre-supposes income chargeable to tax

- The words “chargeable under the provisions of the Act” used in

¹²⁰ CIT and ITO v. Samsung Electronics Co. Ltd., Raffles Software (P) Ltd., Sonata Information Technology Ltd., Sonata Software Ltd., Hewlett Packard India Software Operation (P) Ltd., Aparaj Enterprises Solutions Pvt. Ltd. and EDS Technologies (P) Ltd. [2009] 227 CTR 335 (Kar)

Section 195(1) of the Act clearly indicate that payments made to non-residents should partake the character of income chargeable to tax, in order to trigger withholding of tax.

- Payments which do not arise out of any contractual obligation and made voluntarily cannot be regarded as income under the Act.
- Payers are obligated to withhold tax on pure income payments and composite payments i.e. payments which have an element of income embedded therein.
- In case of composite payments, the obligation to withhold tax under Section 195 of the Act is limited to the proportion of income comprised in the payment based on the “principle of proportionality”.
- The fact that the effect of tax treaties can be considered while making payments in the nature of royalties and fees for technical services to non-residents¹²¹ only strengthens the argument that presence of income chargeable to tax is imperative to trigger the requirements of tax deduction at source.
- Bombay HC in the case of Cooper Engineering in the context of Section 18(3B) of the Income-tax Act, 1922 (Similar to Section 195(1) of the Act pointed out that no tax is deductible if the payment made to the non- resident was not chargeable to tax in India.
- Application to the AO under Section 195(2) of the Act is necessary only when the payer is unsure of the portion of payment which would be subject to withholding tax or the quantum of withholding tax. Section 195(2) of the Act is only a safeguard as observed in the Transmission Corporation case.
- Thus the principle of Section 195 of the Act is that the underlying payment should bear the character of income. If the payment is not in the nature of income, he cannot be held as an “assessee in default” for failure to withhold tax.

Significance of Section 195

- The words “chargeable under the provisions of the Act” have been used only in Section 195 of the Act. For instance, Sections 194C, 194EE and 194F of the Act contain the words “any sum paid”.

¹²¹ CBDT Circular 728, dated 30 October 1995

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- The Supreme Court is duty bound to give meaning and effect to the unique expression employed in Section 195 of the Act.
- Thus it follows that provisions enshrined in Section 195 of the Act have to be read and applied in conjunction with the charging sections of the Act, i.e. Sections 4, 5 and 9 of the Act.

If the judgment of the Karnataka HC is accepted, it results in the following anomalies:

- All payments of any nature would constitute income of the nonresidents in India.
- Payers would not be entitled to refund if the particular payment is not income, as Section 237 read with Section 199 of the Act implies that, only the payee could seek a refund.
- Government would collect tax even if the income has no territorial nexus with India or is not chargeable to tax in India.
- The charging section and the machinery section need to be read together as they constitute one integral and inseparable code as held by the Supreme Court in the case of *Eli Lilly*¹²²
- The argument of the tax department that Section 195(2) of the Act facilitates tracking the remittances made to residents cannot be accepted because provisions of Section 40(a)(i) and 195(6) of the Act are adequate safeguards which would prevent revenue leakage.

Transmission Corporation case misinterpreted

- The Karnataka HC has misunderstood the observations of the Supreme Court in the case of *Transmission Corporation*. The words “such sum” used in the *Transmission Corporation* case refer to the element of the payment which is exigible to tax in India in case of composite payments.
- However, the Karnataka HC interpreted the words “Such Sum” to mean any payment made to a non-resident. The Supreme Court viewed that the wordings in *Transmission Corporation* case cannot be interpreted to mean that every payment made to a non-resident is liable to withholding tax under Section 195 of the Act.

¹²² CIT v. Eli Lilly & Co. (India) (P) Ltd. [2009] 312 ITR 225 (SC)

- To clarify, the Supreme Court in Transmission Corporation case held that tax is to be withheld on the entire composite payment, only if an application under Section 195(2) of the Act is not made to the AO to determine the appropriation portion of income chargeable to tax.

The matter referred back to the Karnataka HC

The Supreme Court based on the above observations, remanded the case to the Karnataka High Court to consider the issue on merits and adjudicate whether the payments made to the suppliers was royalty, which would give rise to income chargeable to tax in India.

3. Cairn Energy India (P) Ltd. v. ACIT I.T.A. Nos. 208 to 211 (Mds)/2006 (126 TTJ 226)

The taxpayer, a non-resident company was engaged in prospecting for and production of mineral oils in India. It carried out its activities under a Production Sharing Contract (PSC), approved by the Parliament as per the requirements of section 42 of the Act. The taxpayer had made certain reimbursements to its non-resident parent company in respect of expenditure incurred by the parent company in connection with the business activity carried on by the taxpayer in India and these amounts were claimed as revenue expenditure by the taxpayer under section 42.

The AO disallowed the above expenditure under section 40(a)(i) of the Act on the ground that the taxpayer failed to deduct the tax at source under section 195 of the Act. The CIT(A) confirmed the order of the AO.

The issue came before the Tribunal. The Taxpayer contended that Section 40 of the Act has to be strictly interpreted and its application has to be restricted only to those provisions over which it has the overriding effect i.e. Sections 30 to 38 of the Act. Section 42 of the Act is a special provision and therefore the computation of income had to be made in accordance with that section only and provisions of a Section 40 of the Act being a general section cannot be applied to Section 42 of the Act. Further the payments represented reimbursement of the expenditure incurred by the parent company and had no element of profit in it. Consequently the provisions of Section 195 of the Act could not be applied.

Against the contentions of the taxpayer, the department contended that the provisions of Sections 195 of the Act as well as Section 40(a)(i) of the Act are applicable for all kinds of payments irrespective of the element of profit and that profit element is not required for deduction of taxes at source.

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Section 42 of the Act is only a provision enabling special deductions and not a special provision, therefore the payments covered by section 42 of the Act are subject to application of Section 40(a)(i) of the Act, and Section 42 of the Act does not have an overriding effect on section 40(a)(i) of the Act.

After hearing the contentions, the Tribunal held that :

- A sum can be chargeable to tax only when it contains element of profit, if there is no element of profit embedded, then provisions of Section 195 of the Act would not apply.
- Further the rulings relied upon by the tax department were distinguishable and therefore cannot be applied to the present case.
- The argument of the tax department that the taxpayer has himself deducted taxes at source on similar payments in subsequent years and that the taxpayer cannot argue now that it is not liable for deducting taxes at source, was not accepted in light of the Supreme Court's decision in the case of National Thermal Power Co. Ltd. (229 ITR 383), wherein it has been held that even if the taxpayer has returned an income, the same can be challenged before the appellate authority on the ground that it is not taxable.
- Further, the scheme of the Act makes it clear that the provisions of Section 42 of the Act would prevail over the general provisions of computing income contained in Section 30 to 38 of the Act.
- Provisions of section 40 of the Act cannot be invoked when the income is to be computed under Section 42 of the Act as it is a settled law that general provisions must give way to the special provisions.

4. ITO v. Ariba Technologies (India) Pvt. Ltd. (ITA No.616 (Bang)/2011, dated 4 April 2012)

The taxpayer is engaged in the business of providing data processing, technical consulting, computer programming, technical support and Information Technology (IT) enabled services. The taxpayer entered into separate agreements for programming services, IT enabled products and other services agreements such as Research and Development agreements (R & D agreements). Under the R & D agreements, the personnel of Ariba USA were to assist the taxpayer on short-term basis. One of the agreements termed as 'employee assignment agreement' i.e. secondment agreement, was entered to secure the services of certain personnel of Ariba USA to

assist the taxpayer in its business. In terms of the aforesaid agreement, Ariba USA has provided services of one of its employees to the taxpayer by deputing him to India and his services were rendered in India.

The taxpayer reimbursed the remuneration of the seconded employee to Ariba USA on account of secondment agreement which was in turn remitted to the employee. Further, the taxpayer remitted this amount after deducting tax under Section 192 of the Act. Hence the taxpayer claimed that the tax withholding was not required under Section 195 of the Act while making this payment. However, the AO held that since the tax was not withheld under Section 195 of the Act while making payment to a foreign company for the services rendered by its employee in India hence the taxpayer should be treated as an 'assessee in default' under Section 201(1) of the Act, and AO also levied interest under Section 201(1A) of the Act. The CIT(A), on a perusal of the secondment agreement observed that the net salary was remitted to Ariba USA at the request of employee to be credited to the employee's account in USA. Based on the above facts, the CIT(A) held that once the amount is already taxed in the hands of the employee, the same amount cannot be treated as FTS remitted to the parent company in USA.

Tribunal's ruling

- The Tribunal held that this case was covered by the decision of the Tribunal in the case of IDS India wherein it was observed as follows:
 - Under the Explanation 2 of Section 9(1)(vii) of the Act, FTS does not include consideration which would be income of the recipient chargeable under the head salaries.
 - Article II of the secondment agreement contains the duties and obligations of the seconded employee and Article VI provides for the indemnification. These Articles would be out of place in a contract for providing technical services. Article II makes the seconded employee responsible and subservient to IDS India which cannot be the case if the agreement is for providing technical services by IDS USA to IDS India.
 - Certain clauses of the secondment agreement requires the seconded employee to also act as a officer or authorised signatory or nominee or in any other lawful personal capacity for IDS India which would be out of place in agreement for rendering technical services as it cannot be imagined that a

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technical person would also be required to act in non-technical capacities under an agreement for rendering technical services.

- The seconded employee was appointed as a Managing Director by the Board of Directors of IDS India and not by IDS USA. In fact, IDS India could even terminate the services of the Managing Director during the period of such service.
 - The salary paid by IDS India to the seconded employee has been subjected to tax deduction at source and the same has been remitted to the Indian Income tax authorities.
 - Based on the above, the Tribunal had held that IDS India was not liable to deduct tax under Section 195 of the Act, from the amount paid by it to IDS USA, representing reimbursement of the salary to the seconded employee. Further the Tribunal held that the payment to IDS USA did not represent 'FTS'
- In view of the reasoning given above in the case of IDS India the Tribunal has held that the taxpayer is not liable to deduct tax under Section 195 of the Act while making the payment to the foreign companies on the transactions of the salary payable to the employee of the foreign company for the services rendered by him to the taxpayer in India in terms of the secondment agreement, wherein the taxpayer has already withheld the tax under Section 192 of the Act while making this payment.

5. **Wipro Ltd. v. ITO [IT(IT) A. Nos.1544 to 1547/Bang/2013, (AY 2011-12)]**

The taxpayer filed its quarterly electronic tax deduction at source returns in Form No.27Q in respect of the payment made to non-residents. The AO issued an intimation providing a summary of the short deduction and interest payable for delayed deposit of tax. The AO along with an intimation under Section 200A the Act also issued a demand notice under Section 156 of the Act. The taxpayer contended before the CIT(A) that the AO issued the demand without giving effect to the provisions of the tax treaty. The taxpayer had deducted tax in accordance with the provisions of the respective tax treaty and therefore, there was no shortfall in the deduction of tax at source in respect of the payments made to non-residents. The CIT(A) confirmed the action of the AO.

The Bangalore Tribunal observed that an identical issue was considered and decided by the Pune Tribunal in the case of Serum Institute of India Ltd. [2015] 56 taxmann.com 1 (Pune). Reliance was also placed on the decision of the Karnataka High Court in the case of Bharti Airtel Ltd. [2014] 52 taxmann.com 31 (Kar). The Bangalore Tribunal held that the provisions of Tax Deducted at Source (TDS) had to be read along with the tax treaty for computing the tax liability on the sum in question. Therefore, when the recipient is eligible for the benefit of a tax treaty, then there is no scope for deduction of tax at source at the rate of 20 per cent as provided under the provisions of Section 206AA of the Act. Similarly, on the issue of jurisdiction, it was held that the question of computing the rate of 20 per cent under Section 206AA of the Act is a debatable issue when the recipient is eligible for the benefit of provisions of the tax treaty, and therefore, the AO cannot proceed to make the adjustment while issuing an intimation under Section 200A of the Act.

6. Satyam Computer Services Ltd. [2015] 380 ITR 189 (AAR)

The applicant is an Indian company incorporated under the Companies Act, 1956. The applicant's shares are listed on the National Stock Exchange of India (NSE) and the Bombay Stock Exchange (BSE). Further, the applicant's American Depositary Shares (ADS) were listed on the New York Stock Exchange (NYSE). A complaint was filed by the U.S. Securities and Exchange Commission (SEC) against the company in the U.S. Court. The SEC prayed before the U.S. Court for imposing a civil monetary penalty in pursuance of the provisions of the Securities Exchange Act, 1934 (the Exchange Act) and alleged violations of the Securities Exchange Act, 1934 and the Exchange Act Rules.

The applicant filed its consent and undertaking with the SEC on 31 March 2009, without admitting or denying the allegations in the complaint, agreeing to pay an amount of USD10 million as a penalty and other restraints. Based on the consent and the undertaking, the U.S. Court passed its final judgement/decree against the applicant on 6 April 2011, adjudging that the applicant is liable to pay a civil penalty of USD10 million in pursuance of the provision of the Exchange Act. The U.S. Court further held that the 'amount ordered to be paid as civil penalties pursuant to this judgement shall be treated as penalties paid to the government for all purposes, including all tax purposes.' The issue before the AAR was whether the penalty amount payable in pursuance to the final judgement/decree of the U.S. Court and

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paid to the U.S. government /U.S. Court would be liable to tax deduction at source under the provisions of the Act.

AAR's ruling

It is a trite law that unless the payment made attracts tax under the Act, there would be no liability to deduct tax under Section 195 of the Act. A penalty ordered by the U.S. Court can never attract any tax nor would such a payment made by an applicant attract any tax liability. It is, therefore, axiomatic that the payment being a penalty amount as ordered by the court of competent jurisdiction for the same, can never attract any such tax liability. Hence, the applicant would not be required to deduct any such amount under Section 195 of the Act. The tax department has conceded that there would be no necessity of deducting tax from the penalty amount of USD10 million.

7. DCIT v. Kothari Food & Fragrances [2014] 166 TTJ 479 (Lack)

Kothari Foods & Fragrances (KFF) is an exporter, and against the export proceeds receivable from the overseas buyer, the taxpayer allowed a discount for making advance payment. During the Assessment Year (AY) 2008-09, KFF allowed a discount of INR5.63 million on sales made to foreign buyers for making advance payment.

The AO held that discounts credited in the foreign buyers account in KFF's books of accounts constituted a 'credit', though not 'payment', and therefore Section 195(1) of the Act would apply. Since KFF had debited an equivalent amount as expenditure, by not deducting or withholding tax on such payment, the AO disallowed the expenditure on account of discount allowed under Section 40(a)(i) of the Act. However, the CIT(A) deleted the additions made by the AO.

On a perusal of the purchase contract, it was indicated that the seller shall cause the issuance of a banker's guarantee or standby letter of credit by the seller's bank for an amount equal to the provisional price, plus interest in the form acceptable to the buyer, and that will be informed in a separate message.

The Lucknow Tribunal observed that within two business days from the date when the buyer's bank receives the bank guarantee, the buyer shall pay to the seller the pre-payment amount. Hence, it was not mentioned in the purchase contract that any pre-payment discount will be allowed by KFF.

The payment to be made by the buyer was the provisional price after furnishing the bank guarantee by KFF. As per the purchase invoices, pre-

payment discount was allowed by KFF, and KFF asked the buyer to make the payment of the balance amount against the invoiced price after adjusting the advance received by KFF and the pre-payment discount. Asking the buyer to pay lesser amount after adjusting discount or making payment of discount to the buyer is equivalent to the buyer receiving benefit out of it.

The Tribunal observed that the benefit allowed by KFF to its buyers under the name of discount was in the nature of interest as the same was in consideration of receiving the advance payment. On receiving the advance payment, one may compensate the maker of advance payment by way of allowing interest, or the same benefit can be given in the name of discount, but merely because a different nomenclature has been given, it does not change its character. Accordingly, the Tribunal held that TDS was deductible under Section 195 of the Act on the discount allowed to foreign buyers for making advance payment and consequently, the disallowance made by the AO was justified.

Foreign Tax Credit

1. Dr. Reddy's Laboratories Ltd. v. ACIT [2017] 53 ITR(T) 285 (Hyd)

The taxpayer granted a loan to its subsidiary in Cyprus, and the subsidiary paid interest to the taxpayer. As per Article 11 of the India-Cyprus tax treaty, 10 per cent of the gross amount of interest is chargeable to tax in Cyprus. The taxpayer submitted that the domestic law at Cyprus provides the tax incentives for the promotion of economic development in Cyprus and therefore, there was no withholding of tax on interest amount remitted to the taxpayer in India. Article 25 of the India-Cyprus tax treaty provides for the tax credit in India with respect to taxes withheld/levied in Cyprus on the interest amount, and notwithstanding that no tax has in fact, been withheld as mentioned above. Accordingly, the taxpayer claimed a tax credit at 10 percent of the gross amount received from Cyprus. The DRP observed that Cyprus did not levy any tax and therefore, the claim for credit of tax payable in Cyprus was rejected. The DRP held that AO has to compute the tax on interest income and allow the tax attributable to interest income under the India-Cyprus tax treaty. The AO is directed to verify whether the taxpayer has paid tax on interest income, and if the tax is paid then allows the deduction for tax deemed to have been paid.

The Tribunal remanded the matter to the file of the AO to verify whether the taxpayer has paid tax on interest income in India, and if so, to allow the

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deduction of the tax admitted to have been paid under Article 25(2) read with Article 25(4) of the tax treaty.

2. Bhavin A Shah v. ACIT [2017] 164 ITD 610 (Ahd)

The taxpayer is an individual, resident in India, and is in employment of JP Morgan India Pvt Ltd. as Managing Director and Global head of technology research of the company. During the year under consideration the taxpayer earned dividend income from foreign securities in the United States and the taxes withheld from such dividend income was of INR3,72,698. The taxpayer claimed tax credit under Section 90 of the Act with respect to dividend income earned outside India. The AO declined the tax credit claim of the taxpayer, in respect of tax of INR3,72,698 deducted from its dividend earnings in the United States on the ground that relief will be available on actual payment made in the return of income filed in USA and tax paid thereon and tax credit cannot be given on simply TDS from foreign dividend income. The CIT(A) upheld the order of the AO.

The Ahmedabad Tribunal held that the taxpayer can claim Foreign Tax Credit (FTC) in respect of taxes deducted in the U.S. against dividend income on satisfaction of the conditions specified in the FTC Article of the India-USA tax treaty. Furthermore, where tax deduction is at a rate higher than the rate prescribed in the tax treaty, the taxpayer will be eligible to claim FTC restricted to the amount computed based on the rates prescribed in the tax treaty.

3. Elitecore Technologies Pvt Ltd v. DCIT [2018-TII-121-ITAT-AHM-INTL]

During the Assessment Year 2010-11, the taxpayer had some receipts from the contract in Singapore and Indonesia. As per the rules of the income tax in those countries, the tax had been deducted on the payment. The taxpayer therefore claimed the deduction on account of taxes paid in those countries from the income tax payable on the income in India.

The AO after examining the provisions of Section 90 of the Act and the relevant clauses of India-Singapore and India-Indonesia tax treaties, allowed only part of the tax paid as against full credit of foreign tax deducted claimed by the taxpayer. For this purpose, he computed proportionate profit on the receipts from these countries and calculated the income which was being taxed again in India. For calculating the Foreign Tax Credit (FTC), the AO calculated the tax payable on that proportionate income and allowed the credit off the proportionate tax out of the FTC.

The Ahmedabad Tribunal held that the amount of tax paid in respect of income arising in a foreign country and subjected to tax both in India and the foreign country shall be allowed as a FTC against Indian tax payable in respect of such profits or income in such manner that the credit should not exceed the Indian tax which is proportionate to the income arising in the other country.

The Ahmedabad Tribunal also held that when FTC is not allowed in India on the taxes paid abroad for carrying out business activity then such taxes should be allowed in the hands of taxpayer as 'business expenditure' under Section 37 of the Act.

MFN Clause

1. Steria (India) Ltd. [2014] 364 ITR 381 (AAR)

An Indian company (the Company) entered into a Master services Agreement (the Agreement) with a non-resident partnership firm (the service provider) formed in France to receive various management services.

The company filed an application with the AAR seeking a ruling on the issue of taxability on the payments for the management services in the hands of the service provider, and the company's obligation to withhold tax at the source on such payments.

The company contended that the benefit of the 'make available' clause in the India-U.K. tax treaty, which was signed after 1 September 1989 should be available under the India-France tax treaty (the tax treaty) by virtue of the protocol signed between India and France. Thus in absence of the technical knowledge, experience, skill, know-how or processes being 'made available' by the service provider to the company, the services ought not qualify as FTS under the tax treaty.

The AAR ruled that payment for management services will be taxable as FTS as the benefit of 'make available' clause under the India-U.K. tax treaty cannot be imported to interpret the provisions of the tax treaty with France, inter alia, for the following reasons:

- A protocol cannot be treated in the same way as the provisions [Most Favoured Nation (MFN)] contained in the tax treaty itself, though it may be an integral part of the tax treaty;
- As per the protocol, the restrictions are on the rates and the benefit of 'make available' clause cannot be read into it;

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- The Notification No. GSR 681(E), dated 7 September 1994 and Notification No. 11438 [SO 650(E), (F.No.501/16/80- FTD)], dated 10 July 2000 do not cover the 'make available' clause. Had the intention been to include the 'make available' clause in the India-France tax treaty, it should have been included in the notification.
 - This case has been set aside by the Delhi High Court in the case of **Steria (India) Ltd. vs. CIT (2016) 386 ITR 390 (Delhi HC)** wherein the High Court has stated that in view of clause 7 of 'Protocol' forming part of India-France DTAA, less restrictive definition of expression 'fees for technical services' appearing in Indo-UK DTAA, must be read as forming part of India-France DTAA as well, hence payment by an Indian company to a French company for management services would not constitute Fees for Technical Services under India-French DTAA.
- 2. DCIT v. Sun Pharmaceutical Laboratories Ltd [2018] 96 taxmann.com 105 (Ahd)**

The taxpayer is a large pharmaceutical company. During the assessment years under consideration, the taxpayer made payments to an Israel based entity on account of Active Pharmaceutical Ingredient and formulation services.

The taxpayer claimed that the payments were not in the nature of FTS under the India-Israel tax treaty. It was claimed that FTS article was to be read along with the MFN clause provided in the Protocol to the India-Israel tax treaty. India-Israel tax treaty along with the protocol was signed on 29 January 1996, and subsequent to the said date, India-Portugal tax treaty was notified which contains a 'make available' clause. Therefore, the 'make available' clause provided in India-Portuguese tax treaty, must be read into the India-Israel tax treaty.

The Ahmedabad Tribunal observed that MFN clause contained in the Protocol to the India-Israel tax treaty is applicable prospectively. The MFN clause provided in the Protocol to India-Israel tax treaty does not require anything more than such a more favourable tax treaty coming into force.

The definition of FTS under the India-Portuguese tax treaty covers rendition of only such 'technical or consultancy services' which 'make available' technical knowledge, skills or experience. The Ahmedabad Tribunal referred various decisions² which held the decision in favour of the taxpayer.

The Ahmedabad Tribunal observed that it is an ongoing contract that the taxpayer has entered into with the service provider, and the thrust of the arrangement is essentially for supervisory and consultancy services. These services do not 'make available' technical knowledge, experience, skill, know-how or processes. Therefore, it cannot be treated as FTS by virtue of MFN clause under the India-Israel tax treaty.

3. Ericsson Telephone Corporation India AB v. DDIT [2018] 96 taxmann.com 258 (Del)

The taxpayer, a Sweden based entity, is engaged in the field of telecommunication and mobile telephony. During the year, the taxpayer, inter alia, received fees for rendering certain services.

The AO relied on the AAR ruling in the case of Ericsson Telephone Corporation and held that receipts were taxable as FTS under the India-Sweden tax treaty. Further, the AO invoked the provisions of Section 44D of the Act and held that no deduction should be allowed. The tax rate of 20 per cent under Section 115A of the Act was applied by the AO.

The taxpayer relied on the Protocol to the India-Sweden tax treaty. As per the MFN clause in the Protocol, if India had entered into a tax treaty with a third country which is a member of OECD, where it had limited its taxation rights in terms of rate or scope, which are more beneficial than that provided in the India-Sweden tax treaty, then such lower rate or scope shall apply in preference to the rate or scope of FTS provided in the India-Sweden tax treaty.

The taxpayer contended that India entered into a tax treaty with Finland, which is a member of the OECD. Article 12 of the India-Finland tax treaty deals with 'Royalties and FTS' which contains the 'make available' clause, which was absent in the India-Sweden tax treaty. When the AAR rendered its Ruling in 1996, the new tax treaty between India and Sweden was not entered into. Subsequently, it was notified on 17 December 1997 and came into effect after the AAR ruling was rendered. However, in the instant case, the Assessment Year under consideration is 2000-01. The taxpayer contended that the Protocol under the tax treaty of 1998 had the effect of changing the complexion of the case.

The Delhi Tribunal observed that the Protocol to the India-Sweden tax treaty is to be considered as part and parcel of the tax treaty. There is no question of resorting to a Protocol only if some clarity is needed in the tax treaty. If a

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particular benefit is being conferred, expanded or reduced by the Protocol, which is absent in the tax treaty, then the provisions of the Protocol shall apply only to that extent. A Protocol cannot be viewed as a document independent of the tax treaty and has to be considered as its addendum.

Since the new India-Sweden tax treaty and the Protocol have not been considered by the AO who has gone by the ruling rendered by the AAR, the matter was remitted back to the AO for fresh adjudication.

Tax Residency Certificate

1. Skaps Industries India Pvt Ltd v. ITO [2018] 171 ITD 723 (Ahd)

During the years under consideration, the taxpayer made payments to the U.S. company for the installation and commissioning services of certain equipment. These payments were made without deduction of tax at source.

The taxpayer contended that the payments made were not taxable in India since the installation and commissioning activities were inextricably linked to the purchase of the equipment and there was neither a transfer of technology nor was the technology being made available under the India-U.S. tax treaty.

The AO held that the U.S. company had a high degree of technical expertise and it had the desired level of expertise in installing and commissioning of a machine owned by the taxpayer and therefore, the services were taxable as Fees for Included Services (FIS) under the India-U.S. tax treaty.

The CIT(A) held that in the absence of a Tax Residency Certificate (TRC) and in view of the specific provisions of Section 90(4) of the Act, the U.S. company cannot be granted tax treaty benefits. The installation and commissioning services cannot be said to be for the purchase of equipment and thus covered by exclusion clause provided under Article 12(5)(a) of the India-US tax treaty.

The Ahmedabad Tribunal held that the taxpayer cannot be denied the benefit under the India-U.S. tax treaty on the ground that it has not furnished a TRC. However, the taxpayer has to satisfy the eligibility for the tax treaty benefit. The onus is on the taxpayer to give sufficient and reasonable evidence in support of his residential status so as to satisfy the conditions laid down under Article 4(1) of the India-US tax treaty.

Since the eligibility of U.S. company for tax treaty entitlement in the present case was not established, and therefore, all the arguments of the taxpayer on

the scope of various provisions of the tax treaty were irrelevant. Therefore, the taxpayer was asked to submit evidence in support of his residential status so as to satisfy the conditions laid down under Article 4(1) of the India-U.S tax treaty. The AO did not deal with this aspect of the matter at all and simply proceeded to apply the law on the assumption that the U.S. entity was entitled to the benefits of the tax treaty. However, the CIT(A) had taken note of this legal requirement and asked the taxpayer to produce a TRC under Section 90(4) of the Act which does not dilute the superiority of the tax treaty law over the domestic law.

Accordingly, the matter was remitted to the CIT(A) for fresh adjudication, *inter alia*, on the fundamental aspect of tax treaty entitlement.

Non-discrimination

1. ABN Amro Bank NV v. JCIT (ITA No. 692/Cal/2000, dated 30 March 2001) – (Unreported)

This case pertains to assessment year 1996-97. The taxpayer was a foreign bank incorporated in Netherlands. It carried out banking operations in India and was a non-resident for the purpose of taxation in India. It had a Permanent Establishment in India through its branches. The taxpayer was not a "domestic company" since it did not meet with the conditions laid down under the Finance (No. 2) Act, 1996. For the assessment year 1996-97, domestic companies were taxed at the rate of 46percent (including surcharge of 15percent) and other companies at the rate of 55percent. The taxpayer contended that it should be treated at par with Indian banks carrying on similar operations in India by virtue of Article 24 (Non-discrimination provisions) of the Double Tax Avoidance Agreement (DTAA) between India and Netherlands. The AO accepted the claim of the taxpayer and taxed the taxpayer at the rate of 46percent. The CIT(A) enhanced the assessment based on the decision of the Authority of Advance Ruling (AAR) in the case of *Societe Generale (1999) 236 ITR 103 (AAR)*. He held that tax rate under the Indian tax law was applicable on the basis of rates prescribed in the relevant Finance Act (in the instant case, the same being 55percent), and not on the basis of provisions of the DTAA. Before the Tribunal, the taxpayer contended that it should be given the benefit of the Non Discrimination Provisions under the DTAA. The Tribunal held that the charging section for the levy of income tax is Section 4 of the Act, which provides that tax shall be charged at the rates provided in the Finance Act. The various DTAA's entered

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into by India were very much a part of the Indian Tax Law. It was also well settled that in case of a conflict between the provisions of the DTAA and the provisions of the Act, the provisions of the DTAA would prevail. It placed reliance on the decisions in *CIT v. Davy Ashmore India Ltd (1991) 190 ITR 626 (Cal.)*, *Standard Chartered Bank v. IAC (1991) 39 ITD 57 (Bom.)*, and *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP.)*.

Article 24(1) of the DTAA provides for the non-discrimination between “nationals” (as opposed to “residents”) of one of the contracting States and “nationals” of the other States placed “in the same circumstances”. The term “nationals” would mean citizens in respect of individuals, and bodies corporate incorporated in the respective countries. The Tribunal held that the article 24(1) did not contain any reference to “residence”. Moreover, domestic companies and non-domestic companies could not be said to be “in the same circumstances” as in case of domestic companies, the tax was levied in India on their world wide income which was not the case for non-domestic companies. Therefore these companies could not be said to be “in the same circumstances”. Article 24(1) of the DTAA would therefore not apply to the taxpayer.

As far as the applicability of article 24(2) was concerned, the Tribunal considered the following issues:

- (a) the scope of the expression “taxation” and whether it includes and covers even the provisions relating to rate of tax;
- (b) the meaning of the expression “not be less favorably levied” and whether the word “levied” herein should mean merely computation of income or even imposition of actual tax also; and
- (c) the interpretation of the expression “carrying on the same activities” with special reference to whether the taxpayer and similar non-Indian banks could be considered to be carrying on the same activities as the Indian banks.

The Tribunal held that the expression “taxation” would cover within its fold not only the nature of taxation but also the actual amount of tax, which necessarily takes into account the rate of tax also. As regards the term “levied”, the Tribunal held that the term would mean the actual tax levied and not merely the amount of tax computed. Reliance was placed on the decision in *A.N. Lakshman Shenoy v. ITO (1958) 34 ITR 275* in which case the expressions “levy”, “assessment” and “collection” were discussed.

In as much as similarity of activities was concerned, the Tribunal was of the view that just like any other nationalized bank or private bank, in the capacity of a scheduled bank, the taxpayer was equally subjected to on-site surveillance as well as off-site surveillance. It was required to follow the guidelines of Reserve Bank of India (RBI) in the matter of maintenance of Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), to carry out banking activities within the common framework of rules and regulations as prescribed by the RBI from time to time including Capital Adequacy Norms, Prudential Norms in respect of income recognition and provisioning for losses and Lending Norms and also Priority Sector Lending Norms, as applicable to Indian Banks, albeit in respect of a lesser percentage of the total advances. There was substantially no difference in the activities carried on by Indian banks (at least the private Indian banks) and foreign banks. It, therefore, saw no reason why foreign banks should suffer discrimination as against Indian private banks.

It therefore held that the provisions of Article 24(2) of the DTAA squarely applied to the taxpayer. It further held that, when the Finance Act prescribes discriminatory rates of taxes for domestic and non-domestic companies and the concerned DTAA provides for non-discrimination between permanent establishment of the enterprise of the foreign state with enterprises of the Indian State, in view of the accepted position that the provisions of DTAA do prevail over the national law, the discriminatory position as provided in the Finance Act are certainly required to be considered non-operative. It also referred to the letter *Ref. D.O. No. 500/45/94-FTD dated 21 November 1994*, where the Central Board of Direct Taxes (CBDT) had also held that the rate of tax applicable to the taxpayer would be the same as that for an Indian company.

It further pointed out that the DTAA with a number of countries like Bulgaria, Canada, China, Cyprus, Finland, Germany, UK, etc make a specific mention that non-discrimination provision shall not be construed as preventing a contracting state from charging the profits of a Permanent Establishment which an enterprise of the other Contracting State has in the first mentioned contracting state. It also pointed out that in certain cases like in the case of DTAA with Canada, the maximum difference between the rates of tax to be charged on the enterprises of the two different contracting states under consideration has also been specifically provided.

It distinguished the case of the taxpayer from the decision of the Calcutta Bench of the Tribunal in the case of *The Bank of Tokyo-Mitsubishi Limited*

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I.T.A. No. 1991/Cal/95 dated 31 March 1997 and held that in the DTAA with Netherlands there is no Article corresponding to Article 23(1) of the DTAA with Japan. Hence, the general principle of International Law about subjugation of the Indian Laws to the specific provision of the treaty was held to hold good.

It concluded that by virtue of Article 24(2) of the DTAA with the Netherlands, (non-discrimination) the company could not be subjected to taxation in a less favourable manner than that applicable to Indian companies.

2. Societe Generale v. CIT [2001] 251 ITR 657 (SC)

The applicant, a non-resident banking company had made an application for advance ruling. The question on which an advance ruling was sought was: Whether the applicant could claim the benefit of the lower rate of tax on domestic companies in view of Article 26 (non-discrimination) of the DTAA between India and France. The assessment year in question was 1996-97.

The revenue authorities contended that the AAR did not have jurisdiction to decide the question, as per the provisions of Section 245R of the Act as assessment proceedings for the assessment year 1996-97 were pending before the tax authorities.

The members of the AAR accepted the objection but still decided the question on merits. The AAR held that the rate of tax fixed by an Act of Parliament (even if the rate of tax on non-domestic companies was higher) could not be whittled down by reference to the DTAA, even though such DTAA had the force of law. No recourse could be taken under the DTAA.

The applicant appealed to the Supreme Court, by filing a special leave petition, to set aside the aforesaid ruling given by the AAR. The applicant also applied for leave to withdraw the application before the AAR. It submitted that it would raise the issue regarding rate of tax for the assessment year 1996-97 and subsequent assessment years before the income-tax authorities. Therefore, having regard to the withdrawal of the application itself, the order thereon should also be set aside.

The revenue authorities did not raise any objection and agreed that the ruling would not be relied upon. Thereupon, the Supreme Court set aside the order of the AAR. The Court also held that the applicant could raise the issue of tax rate before the authorities, the Tribunal and the Courts. These bodies would decide the issue independently without any reference to the ruling of the AAR.

3. Bank of America v. DCIT [2001] 78 ITD 1 (Mum)

Article 14(2) of the DTAA between India and the United States of America provides that a company, other than a domestic company, is permitted to be subject to tax in India at a rate higher than that applicable to domestic companies. The difference between the rates of tax applicable to the foreign company and that applicable to domestic companies, however, should not be more than 15 percentage points. The Tribunal had to decide whether this difference was to be computed with regard to tax excluding surcharge.

For the assessment years, dealt with in this case, domestic companies were subject to tax at the rate of 45 per cent, plus a surcharge of 15 per cent. Thus, the effective rate was 51.75 per cent. The rate prescribed for other companies was 65 per cent.

The taxpayer company, which was a US resident, claimed that the rate of tax in its case could not exceed the rate applicable to domestic companies by more than 15 percentage points. The AO held that the rate of 65 per cent, applicable to a foreign company, should be restricted to 60 per cent in the case of the taxpayer Company, to ensure that the difference in the rate of tax does not exceed 15 per cent and is within the limits set under Article 14(2) of the Indo-US DTAA.

The Commissioner of Income-tax, invoked his revisionary powers under section 263 of the Act and held that, the effective rate of tax applicable to domestic companies was 51.75 per cent, thus in the case of the taxpayer Company, the rate applicable could not be more than 66.75 per cent. As the Finance Act prescribed the rate of income tax applicable to foreign companies at 65 per cent, the taxpayer Company should be subject to tax at this rate.

When the matter reached the Tribunal, it observed that though surcharge was part of income tax, yet, the rate of income tax and surcharge had different connotations. The rate of tax, as referred to in the Indo-US DTAA was that prescribed under article 270 of the Constitution of India. The surcharge is an additional tax, which is not intended to be taken into account for the purpose of placing a limit in the levy of tax in the case of foreign companies.

The Tribunal pointed out that in case of domestic companies the Parliament has exercised its option of imposing additional levy under article 271 of the Indian Constitution but had excluded foreign companies from this additional levy.

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Since surcharge has been treated as different from the rate of tax, the AO was justified in restricting the rate of tax in the case of the taxpayer Company to 60 per cent.

4. ITO v. Decca Survey Overseas Ltd. (ITA No. 3604/Bom/94 dated 27 February 2004)

The taxpayer, a company resident in the United Kingdom, contended for the assessment year 1988-89 that it should be taxed at the rate applicable to domestic companies in view of the Non-Discrimination Article (Article 23) in the DTAA¹²³ between India and UK.

The AO did not accept this contention but the CIT (A) ruled in the Company's favour and set aside the order of the AO. The AO preferred an appeal to the Mumbai Bench of the Tribunal against the order of the CIT (A).

The Tribunal dismissed the appeal by its order dated 22 July 2002 on the ground that this issue had already been decided in the Company's favour in the appeal for assessment year 1989 - 90 (*ITA No. 8489 / Bom / 91 dated 24 September 1988*).

The tax authorities subsequently filed a Miscellaneous Application (*M. A. No.201/Mum/2003*) drawing the attention of the Tribunal to the *Explanation* below Section 90(2) of the Act, introduced by the Finance Act, 2001 with retrospective effect from 1 April 1962. The tax authorities contended that the Tribunal had not considered this *Explanation* while passing the order dated 22 July 2002, which was a mistake apparent from the record. The Tribunal accepted this contention of the tax authorities, recalled its earlier order and put up the matter for a fresh hearing.

In its order dated 11th September 2003, the Tribunal also observed that it would not like to examine the controversy as to whether any arrangements have been prescribed for declaration of dividends or not and whether rule 27 of the the Rules is applicable or not.

In the fresh hearing, the Tribunal examined whether the *Explanation* to section 90(2) of the Act made any difference to the order of the Tribunal for

¹²³ Old DTAA notified vide Notification No. 6/2 (E) dated 23 November 1981 which is no longer operative in view of new treaty notified vide Notification No. 91(E) dated 11 February 1994.

the assessment year 1989-90. The Tribunal has considered the DTAA between India and UK and held that the Act discriminated on the grounds of nationality in the sense that a foreign company was assessed to tax at a much higher rate as compared to a similarly placed in Indian Company. The Tribunal also held that the provisions of the DTAA would prevail over those of the Act.

The *Explanation* to section 90(2) of the Act inserted with retrospective effect from 1 April 1962, which states that merely because a higher rate of tax has been prescribed for a foreign company, compared to the tax rate for a domestic company, it cannot be construed as discriminating between the two, is hedged by a condition that the foreign company should not have made the prescribed arrangements for declaration and payment of dividends within India payable out of its income in India.

The Tribunal considered and accepted the contention of the taxpayer company that the *Explanation* has not been activated by the Legislature by framing rules as to what would amount to the 'prescribed' arrangements for distribution of dividends and therefore, the explanation cannot be applied at all. Rule 27 of the Rules, to which the tax authorities drew the Tribunal's attention, lays down the prescribed arrangements for declaration of dividends within India, was only for the purpose of sections 194 and 236 of the Act. The said rule did not refer to section 90 of the Act. The tax Authorities were also not able to draw the Tribunal's attention to any rule in the Rules, framed for the purpose of section 90 listing out the prescribed arrangements within the meaning of that section.

The Tribunal held that the *Explanation* thus remained a dead letter and the tax authorities could not place any reliance on it. Therefore, the order of the Tribunal for assessment year 1989-90 continued to govern the case for the year in question.

Following its own order for the assessment year 1989-90, the Tribunal confirmed the direction of the CIT (A) to tax the Company at the rate applicable to a domestic company and dismissed the appeal of the tax authorities.

The Tribunal, therefore, held that in the case of foreign companies, having a presence in India and being taxed on their business profits, the Indian rate of tax should be at par with that applicable to an Indian company.

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5. Daimler Chrysler India Private Limited v. DCIT [2009] 29 SOT 202 (Pune)

The taxpayer was a company incorporated in India and was a subsidiary of a German company, ABC. In the financial year 1998-99, ABC and XYZ, USA merged to form a new company in Germany, namely ABZ. All the assets and liabilities of ABC were transferred to ABZ. One of these assets was ABC's shareholding in the taxpayer company. The taxpayer had incurred business losses upto the financial years 1997-98.

The AO held that the business losses could not be allowed to be carried forward and set off in view of the applicability of Section 79¹²⁴ of Act as there was a change in more than 51 percent of the shareholding and the taxpayer was not a company in which public were substantially interested. Further, such closely held companies were not entitled to the benefit of carry forward and set off of losses of earlier year because the amendment to Section 79¹²⁵ of the Act giving relief to the Indian subsidiaries of foreign companies came into effect from 1 April 2000. In any case, it had no relevance with the present case as the tax assessment year was 1999-2000. Accordingly, the AO held that the taxpayer was not entitled to carry forward and set off the accumulated losses.

CIT(A) confirmed the order of the AO. Issues raised for consideration

- Whether the taxpayer was entitled to carry forward and set off accumulated business losses in view of the provisions of Section 79 of the Act and pursuant to the merger of taxpayer's parent company into a new company?

¹²⁴ Section 79 provides that where any change in shareholding has taken place in the case of a company, not being a company in which public are substantially interested, no loss incurred in any year prior to the previous year shall be carried forward and set off against income of previous year unless on the last date of the previous year, the shares of the company carrying not less than 51 percent of the voting power were substantially held by the persons who beneficially held the shares of the company carrying not less than 51 percent of the voting power on the last day of the year or years in which the loss was incurred

¹²⁵ Amendment to section 79 provides that nothing contained in this section shall apply to any change in the shareholding of an Indian company which is a subsidiary of a foreign company as a result of amalgamation or demerger of a foreign company subject to the condition 51 percent shareholders of the amalgamating or demerged foreign company continue to be the shareholder of the amalgamated or the resulting foreign company

- Whether protection was available under non-discrimination provisions under Article 24(4)4 of the DTAA on the ground that the foreign parent company should be regarded as company in which 'public were substantially interested' since it was listed on an international stock exchange?

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- The benefits of the treaty provisions could not be viewed as options being available to the taxpayer, which the taxpayer may or may not invoke. The Act could not be viewed in isolation with the restrictions placed on its applicability.
- As the treaty benefits were not specifically invoked by the taxpayer at the stages of assessment and first appellate proceedings, the taxpayer could not be precluded from seeking treaty protection at the appeal before the Tribunal.
- As long as the related facts were available from records, admission of a legal plea, even at the stage of second appellate proceedings before the Tribunal, could not be declined. In this connection, reliance was placed on the decision of the Supreme Court of India in the case of National Thermal Power Co Ltd¹²⁶

DTAA would apply even if there is no double taxation. Treaty protection would be available

- The role of the tax treaties was not only confined to avoiding double taxation but it was a tool for fostering economic relations, trade and investment. Consequently, treaty override, even before the 2004 amendments in Section 90(1) of the Act, covered all provisions of the DTAA, including the provisions relating to non-discrimination. It cannot thus be inferred that only such provisions of a DTAA can have overriding effect as are in direct consonance with the provisions of Section 90(1) of the Act.
- Section 90(2) of the Act came into existence by Finance Act 1991, though with retrospective effect from 1 April 1972. However, the treaty override was available in the Act right since its inception. Further, the treaty override was not only because of the provisions of Section 90(2)

¹²⁶ National Thermal Power Co Ltd. v. CIT [2002] (229 ITR 383) (SC)

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of the Act. On the contrary, Section 90(2) of the Act was a rider to otherwise unqualified treaty override envisaged in Section 90(1) of the Act, and it only clarified that the treaty override was only to the extent the same was beneficial to the taxpayer.

- The Tribunal observed that the amendment was clarificatory in nature and this view was supported by the Supreme Court decision in the case of Azadi Bachao Andolan, where the Supreme Court, while interpreting DTAA between India and Mauritius(entered into in 1984) held that the DTAA is mainly for encouragement of mutual trade and investment.
- Reference was also made to Circular No. 3337 where it was clarified that the correct legal position is that where a specific provision is made in the DTAA, such provision would prevail over the general provisions contained in the Act. The circular clearly provides for an unqualified tax treaty override irrespective of the provisions of the Act, to the extent it is beneficial to the taxpayer.
- The Tribunal, based on the above, was of the view that the treaty override (even before the amendment of 2004) covered all the provisions of the tax treaties, including the provisions relating to non-discrimination.
- The treaty protection under Article 24(4) was available to the Indian subsidiaries, as long as the capital of such enterprise was wholly or partly owned or controlled, directly or indirectly, by one or more residents of Germany. Such an enterprise could not be subjected to any taxation in India and the taxpayer was entitled to the benefit of the non- discrimination provision of the DTAA.

Interpreting various terms under the non-discrimination clause [Article 24(4)] the loss has been allowed to be carried forward and setoff

- The term “other similar enterprises of India” means a company which is subsidiary of a domestic company and not a company which is a subsidiary of a foreign company.
- The Tribunal observed various International judicial precedents and held that for the purposes of non discrimination prohibition under Article 24(4) in the present context, what required to be examined was whether Indian subsidiary of a German company was any worse off vis-à-vis an Indian subsidiary of an Indian company.

- The status of 'a company in which public are substantially interested' has important tax implications inasmuch as the disability of carry forward and set off of accumulated losses was not attracted in a case of a company in which public are substantially interested.
- When an Indian subsidiary had an Indian parent company shares of which were listed on any recognised stock exchange of its domicile country i.e. India, the Indian subsidiary company was treated as a company in which public were substantially interested. However, when an Indian subsidiary company had a German parent company shares of which were listed in any stock exchange in its domiciled country, i.e. Germany, the subsidiary company was not given the status of a company in which public were substantially interested. There was no rational basis for the differentiation in treatment.
- The basis of differentiation was the stock exchange in which shares of the parent company were listed but it was impossible for a German parent company to get its shares listed on a recognised stock exchange in India. Therefore, the taxpayer being subjected to requirements connected with taxation which are more burdensome vis-à-vis an Indian subsidiary of an Indian parent company was indeed unreasonable. It was not merely a case of differentiation in treatment, but, as differentiation was on unreasonable grounds, it was a case of discrimination which was prohibited under Article 24(4) of the DTAA.
- The Tribunal finally held that section 79 read with section 2(18) of the Act was discriminatory to the Indian subsidiary of a German company as compared to the Indian subsidiary of an Indian company because while the latter was a company in which the public are substantially interested by virtue of the holding company being listed on an Indian stock exchange, the former is not even though its holding company was listed on a German stock exchange. There was no justification for this differentiation in treatment.
- Taking into account the provisions of section 21 of the Securities Contracts (Regulation) Act, 1956, Listing Agreement of various stock exchange(s) including BSE and SEBI (Disclosure and Investment Protection) Guidelines, it is clear that it is not possible for shares of any foreign company to be listed in India.
- Accordingly, it was held that under section 79 of the Act the taxpayer was entitled to carry forward of accumulated losses in case of transfer

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of 51 percent or more share capital of Indian subsidiaries of German companies, as long as parent German company was listed in domestic stock exchanges recognised under the German domestic laws. To this extent the rigours of section 79 of the Act must stand relaxed due to treaty override.

6. Central Bank of India v. DCIT (ITA No. 4155/M/2003, 4156/M/2003 and 4157/M/2003)

The taxpayer issued credit cards to its customers which were affiliated to two USA based international agencies i.e. Master Card and VISA card. The international agencies were operating to facilitate credit card transactions of a large number of issuing banks.

These agencies also provided customised software and hardware to the member banks to facilitate the transactions made through credit cards. The agencies charged the member bank for the various services provided by them. The amount charged depended upon the volume of transactions. The taxpayer made payments to these agencies on which tax was not deducted. The AO disallowed the taxpayer's claim of deduction of payments made to the non-resident agencies under the provisions of Section 40(a)(i) of the Act.

On appeal, the CIT(A) observed that the USA companies were having permanent establishment in India through their networking computers and through leased telephone lines. Therefore, the income received by non-residents was taxable in India. Accordingly, CIT(A) confirmed the order of AO.

The matter came before the Tribunal. After hearing the contention of the taxpayer, the Tribunal observed as below:

- a. Article 26 of the DTAA protects the interest of the non-residents vis-à-vis residents. The Article 26 of the DTAA provides that payment made to the non-resident will be deductible under the same conditions as if the payment were made to a resident.
- b. Further, the exceptions provided in the Article 26(3) were not applicable to the present case since Article 12(8) of the DTAA does not apply to the taxpayer as there was no relationship between the taxpayer and the non-residents.

Accordingly, the Tribunal, after relying on the decision of the Delhi Tribunal in the case of Herbal Life International India Ltd., held that no disallowance

under Section 40(a) of the Act can be on account of non deduction of tax at source in case of payments made to non-residents even if the payments made were taxable in India in their hands

7. Mitsubishi Corporation India Pvt. Ltd v. DCIT [2014] 166 TTJ 385 (Del)

The taxpayer was a subsidiary company of Mitsubishi Corporation Japan (MCJ) in India. Mitsubishi Japan operates worldwide through small business segment units called divisions and LO.

During the AY 2007-08, the taxpayer made payments to MCJ for purchase of goods. The AO held that since Mitsubishi Japan had a PE in India, the taxpayer was required to deduct tax from the payments made to Mitsubishi Japan. Since, the taxpayer had failed to deduct tax at source under Section 195 of the Act, the payments were disallowed under Section 40(a)(i) of the Act.

The taxpayer contended that Section 40(a)(i) of the Act is discriminatory in character as no such disallowance was required to be made if the payments for purchases are made to a resident taxpayer. The AO held that neither such disallowance constituted discrimination, nor was it open to a resident taxpayer to invoke provisions of the tax treaty. The AO observed that the taxpayer was resident in India and was not eligible to claim the tax treaty benefits.

The Delhi Tribunal placing reliance on the ruling of DaimlerChrysler India Pvt Ltd v DCIT [2009] 29 SOT 202 (Pune) held that it is not necessary that the taxpayer, in whose case this non-discrimination is invoked, should be resident of, or even national of, the other contracting state.

The Tribunal had a chance to analyse the provision of Article 24(3) of the tax treaty, wherein, the Tribunal agreed with the scope of the deduction neutrality clause in non-discrimination provision under the tax treaty. Therefore, the Tribunal observed that a different treatment to the foreign enterprise per se is enough to invoke the non-discrimination clause in the India-Japan tax treaty.

The Tribunal relying on the decision of Rajeev Kumar Agarwal v. ACIT [2014] 149 ITD 363 (Agra), observed that disallowance under Section 40(a)(ia) of the Act cannot be made in respect of payments made to a resident taxpayer, even in case of non-deduction of tax at source, if related payments were

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taken into account by the non-resident recipient in its computation and appropriate taxes were discharged by the recipient, and return of income was filed. Accordingly, applying the non-discrimination clause, the Tribunal observed that when payments were taken into account by the non-resident recipient in its computation and appropriate taxes were discharged by the recipient, such payments are not liable to disallowance under Section 40(a)(i) of the Act.

Therefore, the Tribunal deleted the disallowance under section 40(a)(i) of the Act and ruled in favour of the taxpayer.

8. Mitsubishi Corporation India Private Limited v. DCIT [2015] 171 TTJ 417 (Del)

The taxpayer, an Indian company, is a wholly owned subsidiary of Mitsubishi Corporation, Japan (MCJ) which is a general trading company headquartered in Tokyo. During the Assessment Year 2010-11, the taxpayer made payment for purchase of goods from its Associated Enterprises (AEs). The Assessing Officer (AO) held that the taxpayer was required to deduct tax at source on the payment made to AEs under the provisions of Section 195 of the Income-tax Act, 1961 (the Act). Having not deducted tax, the AO made disallowance under Section 40(a)(i) of the Act.

The Delhi Tribunal held that in order to invoke the provisions of Section 40(a)(i) of the Act, it is essential that the amount payable by the taxpayer to a foreign company should be chargeable to tax in the hands of such foreign company. Following the earlier decision of the Tribunal, the Delhi Tribunal in the present case held that AEs did not have any Permanent Establishment (PE) in India. Therefore, the offshore sales made by them to the taxpayer in India would not generate any income chargeable under the Act.

The Tribunal observed that the non-resident is entitled to the benefit of Article 24(3) of India-Japan tax treaty since there is no provision under Chapter XVII of the Act which stipulates deduction of tax at source from payment for the purchases made from an Indian resident. When we compare an Indian enterprise purchasing goods from an Indian party *vis-a-vis* from a Japanese party, there is a discrimination in terms of disallowance of purchase consideration under Section 40(a)(i) in so far as the purchases from a Japanese enterprise are concerned.

The Tribunal observed that the provisions of Article 24(3) shall be restricted to the extent of applicability of Article 9 of the tax treaty. Whatever has been

provided in Article 9 of the tax treaty shall remain intact and will have superseding effect over the mandate of Article 24(3) of the tax treaty. It does not render Article 24(3) redundant in totality. A conjoint reading of these two Articles brings out that if there is some discrimination in computing the taxable income as regards the substance of Article 9, then such discrimination will continue as such. But, in so far as rest of the discriminations covered under Article 24(3), those will be removed to the extent as provided.

Disallowance under Section 40(a)(i) is an independent component of the computation of total income which is distinct from any transfer pricing adjustment. Article 24 read with Article 9 prohibits the deletion of enhancement of income due to the making of transactions at Arm's Length Price (ALP), but permits the deletion of enhancement of income due to the disallowance under Section 40(a)(i) of the Act. The TPO has not proposed any transfer pricing adjustment in respect of 'trading segment' of the taxpayer under which the purchases in question were made. Accordingly, it has been held that the taxpayer is entitled to the benefit of Article 24 of the tax treaty and disallowance cannot be made under Section 40(a)(i) of the Act.