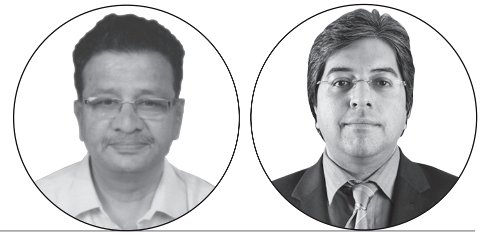
INTERNATIONAL TAXATION



Case Law Update

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A. Supreme Court

1 ***Engineering Analysis Centre of Excellence (P.) Ltd. vs. CIT [2021] 125 taxmann.com 42 (SC)***

Payment made by resident end-users/distributors to the non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the computer software under the EULAs/distribution agreements, did not amount to royalty for the use of copyright in the computer software under Article 12 of the DTAAs – as the distribution agreements/EULAs did not create any interest or right, which would amount to the use of or right to use any copyright – since no right was granted to reproduce the computer programme so as to exploit the same by way of sale, transfer or license etc. Consequently, the said resident end-users/distributors were not liable to withhold taxes u/s 195 of the Act.

Facts

i) The assessee, an Indian Co., imported shrink-wrapped computer software from an F Co. During AY 2001-2002 and 2002-2003, the assessee made payment to the said F Co. for the purchase of shrink wrapped computer software without deduction tax at source.

ii) The Assessing Officer (AO) held that the F Co. had transferred copyright in the said software and hence the payment was taxable as royalty under the Act as well as under the relevant DTAA, and hence the assessee was held as an 'assessee in default'. The Commissioner of Income-tax (Appeals) [CIT(A)] dismissed the appeal of the assessee, however the Tribunal decided in favor of the assessee.

iii) On further appeal, the Karnataka High Court held that since no withholding application was made u/s 195(2) of the Act, the assessee was liable to deduct tax at source u/s 195(1) of the Act.

* assisted by CA Harsh Bafna.

iv) On further appeal, the Hon'ble Supreme Court (hereinafter referred as 'SC') while adjudicating/disposing a batch of 103 connected appeals, categorized the appeals under the following four categories:

a. Sale of software directly by non-resident (NR) - to an end user

b. Sale of Software by an NR - to Indian distributors for resale to end customers in India

c. Sale of software by an NR - to a foreign distributor for resale to end customers in India

d. Sale of software bundled with hardware by an NR - to Indian distributors or end users

v) The SC held as under:

Decision

Applying the provisions of DTAA at the time of withholding taxes u/s 195

i) After taking into consideration the provisions of sections 4, 5, 9, 90 and 195 of the IT Act (the Act), the SC held that once provisions of DTAA are applicable to a non-resident, the provisions of the Act could only apply to the extent that they are more beneficial to the assessee and not otherwise. The SC reaffirming the position laid down in ***GE Technology Centre Pvt Ltd vs. CIT [2010] 193 Taxman 234 (SC)*** and ***Vodafone International Holdings BV vs. UOI [2012] 17 taxmann.com 202 (SC),*** held that the machinery provisions u/s 195 of the Act are inextricably linked with the charging provisions (i.e. sections 4, 5 and 9), as a result of which, tax withholding obligations arise only when the payment to the non-resident is chargeable to tax under the provisions of the Act, read with the DTAA.

ii) The SC also referred to the CBDT Circular No 728 dated 30 October 1995, wherein it is clarified that the tax deductor should take into consideration the effect of the DTAA provisions in respect of payment of royalties and technical fees while deducting taxes at source u/s 195 of the Act.

iii) Further, the SC also distinguished the decision of SC in case of ***PILCOM vs. CIT [2020] 271 Taxman 200 (SC)*** by observing that the said judgement was in the context of section 194E of Act, dealing with "income" payable to a non-resident sportsman and does not have any reference to payments made to non-resident being "chargeable to tax" as in section 195 of the Act.

iv) The Revenue argued that based on Article 30 of the India-USA DTAA, the DTAA's provisions in these cases would not apply at all, in as much as provisions relatable to deduction of TDS under section 195 of the Act do not refer to tax at all, but are deductions that are to be made before assessments to tax are made. The aforesaid argument was rejected by the SC for the reason that the said Article could not be read out of context and that the said Article 30 was only dealing with the 'entry into force' provisions which was to be determined as per the domestic municipal laws.

Relevance of the Copyright Act, 1957

v) Explanation 4 to section 90 of the Act provides that if any term used in the DTAA is defined therein, the said term shall have the same meaning as assigned to it under the said DTAA; and where any term is not defined in the DTAA, but defined in the Act, the said term shall have the same meaning as assigned to it in the Act and explanation, if any, given to it by the Central Government.

vi) Article 3(2) of the DTAA provides that any term not defined in the DTAA shall, unless the context otherwise requires, have, the meaning which it has under the law of that State concerning the taxes to which the DTAA applies.

vii) Further, the SC observed that the expression "copyright" has to be understood in the context of the statute which deals with it, it being accepted that municipal laws which apply in the Contracting States must be applied unless there is any repugnancy to the terms of the DTAA.

viii) Section 16 of the Copyright Act provides as follows –

"16. No copyright except as provided in this Act.-- No person shall be entitled to copyright or any similar right in any work, whether published or unpublished, otherwise than under and in accordance with the provisions of this Act ……."

ix) Section 14 of the Copyright Act provides as follows–

"14. Meaning of copyright.-

For the purposes of this Act, copyright means the exclusive right subject to the provisions of this Act, to do or authorise the doing of any of the following acts in respect of a work or any substantial part thereof, namely–

(a) in the case of a literary, dramatic or musical work, not being a computer programme,--

(i) to reproduce the work in any material form including the storing of it in any medium by electronic means;"

(ii) to issue copies of the work to the public not being copies already in circulation;

……….

(b) in the case of a computer programme–

(i) to do any of the acts specified in clause (a);

(ii) to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme:

Provided that such commercial rental does not apply in respect of computer programmes where the programme itself is not the essential object of the rental."

x) Section 2(y) of the Copyright Act provides as follows–

"(y) "work" means any of the following works, namely:—

(i) a literary, dramatic, musical or artistic work;

……….

xi) Section 2(O) of the Copyright Act provides as follows–

"(o) "literary work" includes computer programmes, tables and compilations including computer databases;"

xii) Section 2(ffc) of the Copyright Act provides as follows–

"(ffc) "computer programme" means a set of instructions expressed in words, codes, schemes or in any other form, including a machine readable medium, capable of causing a computer to perform a particular task or achieve a particular result;"

xiii) Section 30 of the Copyright Act provides as follows–

"30. Licences by owners of copyright.

The owner of the copyright in any existing work or the prospective owner of the copyright in any future work may grant any interest in the right by licence in [writing by him] or by his duly authorised agent:

.....

xiv) Section 52 of the Copyright Act provides as follows–

"52. Certain acts not to be infringement of copyright.

(1) The following acts shall not constitute an infringement of copyright, namely,--

....

(aa) the making of copies or adaptation of a computer programme by the lawful possessor of a copy of such computer programme, from such copy–

(i) in order to utilise the computer programme for the purpose for which it was supplied; or

(ii) to make back-up copies purely as a temporary protection against loss, destruction or damage in order only to utilise the computer programme for the purpose for which it was supplied;"

xv) The SC observed that the right to reproduce a computer programme and exploit the reproduction by way of sale, transfer, license etc. is at the heart of the said exclusive right.

Doctrine of First Sale/Principle of Exhaustion – Section 14(b)(ii) of the Copyright Act

xvi) A copyright owner has an exclusive right to make copies and distribute the same.

xvii) On the first occasion when the copyright owner parts with its distribution rights (i.e. the right to distribute copies of the work), his rights in the work gets exhausted. This is known as the Doctrine of First Sale/Principle of Exhaustion.

xviii) Revenue argued that the Doctrine of First Sale/Principle of Exhaustion was not applicable to the sale of software in light of the provision of section 14(b)(ii) of the Copyright Act, which is reproduced as under:

"14. Meaning of copyright.

For the purposes of this Act, copyright means the exclusive right subject to the provisions of this Act, to do or authorise the doing of any of the following acts in respect of a work or any substantial part thereof, namely--

....

(b) in the case of a computer programme–

....

(ii) to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme (regardless of whether such copy has been sold or given on hire on earlier occasions – deleted)"

xix) The SC observed that - "After the 1999 Amendment, what is conspicuous by its absence is the phrase "regardless of whether such copy has been sold or given on hire on earlier occasions". This is a statutory recognition of the doctrine of first sale/principle of exhaustion."

xx) The SC referred to the locus classicus on the subject i.e. Copinger and Skone James on Copyright (14th Edition) (1999), as follows:

"The distribution right: general. One of the acts restricted by the copyright in all work is the issue of the original or copies of the work to the public, often called the "distribution right".

....

"Exhaustion of the distribution right: tangible objects. Exhaustion applies to the tangible object into which a protected work or its copy is incorporated if it has been placed on the market with the copyright holder's consent."

xxi) The SC referred to the decision of Delhi High Court in case of ***Warner Bros. Entertainment Inc. vs. Santosh V.G., CS (OS) No. 1682/2006*** reported in 2009 SCC OnLine Del 835, wherein the Single Judge bench held as under:

"58. Exhaustion of rights is linked to the distribution right. The right to distribute objects (making them available to the public) means that such objects (or the medium on which a work is fixed) are released by or with the consent of the owner as a result of the transfer of ownership. In this way, the owner is in control of the distribution of copies since he decides the time and the form in which copies are released to the public. Content-wise the distribution right is to be understood as an opportunity to provide the public with copies of a work and put them into circulation, as well as to control the way the copies are used. The exhaustion of rights principle thus limits the distribution right, by excluding control over the use of copies after they have been put into circulation for the first time."

xxii) The SC observed that likewise, when it comes to section 14(a)(ii) of the Copyright Act, the distribution right subsists with the owner of copyright to issue copies of the work to the public, to the extent such copies are not copies already in circulation, thereby manifesting a legislative intent to apply the doctrine of first sale/principle of exhaustion, as has been found by the High Court of Delhi in Warner Bros. (supra).

xxiii) The SC concluded as follows:

"142. ....

Thus, a distributor who purchases computer software in material form and resells it to an end user cannot be said to be within the scope of the aforesaid provision. The sale or commercial rental spoken of in *section 14(b)(ii) of the Copyright Act is of "any copy of a computer programme", making it clear that the section would only apply to the making of copies of the computer programme and then selling them, i.e., reproduction of the same for sale or commercial rental.*

143. The object of section 14(b)(ii) of the Copyright Act, in the context of a computer program, is to interdict reproduction of the said computer programme and consequent transfer of the reproduced computer programme to subsequent acquirers/ end-users.

....

Thus, once it is understood that the object of section 14(b)(ii) of the Copyright Act is not to interdict the sale of computer software that is "licensed" to be sold by a distributor, but that it is to prevent copies of computer software once sold being reproduced and then transferred by way of sale or otherwise, it becomes clear that any sale by the author of a computer software to a distributor for onward sale to an end-user, cannot possibly be hit by the said provision."

Analysis of the License Agreements entered by the F Co. and I Co.

xxiv) W.r.t the distribution agreements, the SC observed as under:

a. It was evident that the distributor was granted only a non-exclusive, non-transferable license to resell computer software and it was expressly stated that no copyright was transferred either to the distributor or to the ultimate end user.

b. Further, no right was granted to sub-license or transfer, nor there was any right to reverse engineer, modify, and reproduce in any manner otherwise than permitted by the licence to the end user.

c. What was paid for by way of consideration by the distributor in India to the F Co., was therefore the price of a copy of the computer programme as goods (direct software sale or hardware embedded with software).

xxv) W.r.t the category where the computer progamme was directly sold to the end user, the SC observed that the end user could only use the computer programme by installing it in the computer hardware and the end user could not reproduce the same for sale or transfer.

xxvi) The SC also observed that the License Agreements in all the appeals did not grant any such right or interest, least of all, a right or interest to reproduce the computer software u/s 14(a) and 14(b) of the Copyrights Act (supra) and such reproduction was expressly interdicted, and it was also expressly stated that no vestige of copyright was at all transferred, either to the distributor or to the end-user.

xxvii) The SC relied on the decision of SC in case of State Bank of India v. Collector of Customs (2000) 1 SCC 727 (though delivered under the Customs Act 1962) and observed that there was a difference between 'right to reproduce' and 'right to use', in as much as that under right to reproduce, there would be a parting of the copyright by the owner thereof, whereas in case of right to use, there would not be parting of any copyrights.

xxviii) With respect to the Revenue's argument that in some of the EULA's, it was clearly stated that what was licensed to the distributor/end users by the non-resident would not amount to sale, thereby making it clear that what was transferred was not goods – the SC, by placing reliance on Sundaram Finance Ltd. v. State of Kerala, (1966) 2 SCR 828, observed that the real nature of the transaction must be looked at upon, by reading the agreement as a whole.

xxix) Relying on the decision of the SC in case of Tata Consultancy Services v. State of AP (2005) 1 SCC 308 (in the context of a sales tax statute), the SC observed that what was "licensed" by the F Co. to the I Co. and resold to the end-user, or directly supplied to the end-user, was in fact the sale of a physical object which contained an embedded computer programme, and was therefore, a sale of goods.

xxx) Thus, the SC held that payments made **by resident end-users/distributors to the non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the computer software under the EULAs/ distribution agreements, did not amount to royalty for the use of copyright in the computer software under Article 12 of the DTAAs – as the distribution agreements/EULAs did not create any interest or right, which would amount to the use of or right to use any copyright – since no right was granted to reproduce the computer programme so as to exploit the same by way of sale, transfer or license etc.**

Definition of royalty under the DTAA and the Act

xxxi) The SC observed that by virtue of explanation 4 to section 90 of the Act and under Article 3(2) of the DTAA, the definition of the term "royalties" shall have the meaning assigned to it by the DTAA, in Article 12. The said position was also clarified by CBDT Circular No. 333 dated 02.04.1982.

xxxii) Taking India-Singapore DTAA as the base, the SC observed that the definition of royalty under the Act was much wider than the definition under the DTAA, for the following three reasons:

a. 'consideration' under the Act also includes lump sum consideration other than income chargeable under the 'capital gains'

b. Granting of a license is expressly included within transfer of "all or any rights"

c. Transfer should be "in respect of" any copyright of any literary work.

xxxiii) Further, the SC also observed that the comma after the word "copyright" does not fit as copyright would obviously exist only in a literary, artistic, or scientific work.

xxxiv) The SC observed that the transfer (license or otherwise) of "all or any rights" (which includes the grant of a license) in relation to copyright is a sine qua non under explanation 2 to section 9(1)(vi) of the Act, in as much as that there should be a parting with an interest in any of the rights mentioned in section 14(b) read with section 14(a) of the Copyright Act.

xxxv) The SC had also observed that there would be no difference in the position between the definition of "royalties" in the DTAAs and the definition of "royalty" in explanation 2(v) of section 9(1)(vi) of the Act, to the extent of the expression "use of, or the right to use".

xxxvi) The SC also held that explanation 4 to section 9(1)(vi) of the Act was not clarificatory in nature (as it expands the definition of royalty), by observing as under:

a. *Explanation 3* to section 9(1)(vi) of the Act which refers to the term "computer software", was introduced for the first time with effect from 1st April, 1991 and therefore explanation 4 could not apply to any right for the use of or the right to use of computer software – even before the term "computer software" was inserted in the statute.

b. Under the Copyright Act the term "computer software" was introduced for the first time in the definition of a literary work, only in the year 1994 (vide Act 38 of 1994).

c. Technology relating to transmission by a satellite, optic fibre or other similar technology, was regulated by the Parliament for the first time through the Cable Television Networks (Regulation) Act, 1995, much after the year 1976.

d. Circular No. 152 dated 27th November, 1974 (cited by the Revenue) would not be applicable as it would then be explanatory of a provision (i.e. section 9(1)(vi) of the Act) that was introduced *vide* Finance Act, 1976

Obligation to withhold taxes pursuant the aforesaid retrospective amendments

xxxvii) The SC, by relying upon two *latin maxims - lex non cogit ad impossibilia,* i.e., the law does not demand the impossible and impotentia excusat legem i.e., when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused, - held that the "person" mentioned in u/s 195 of the Act could not be expected to do the impossible, namely, to apply the expanded definition of "royalty" inserted by explanation 4 to section 9(1)(vi) of the Act, at a time when such explanation was not actually and factually inserted in the statute.

xxxviii) The SC also relied on the decision in case of ***Arjun Panditrao Khotkar vs. Kailash Kushanrao Gorantyal, (2020) 7 SCC 1,*** wherein on the basis of the aforementioned legal maxims, the respondent was relieved of the mandatory obligation to furnish certificate under the Evidence Act, 1872, after failing to obtain it despite several steps taken by the respondent. Further, the SC also referred to the decision of Bombay HC ruling in NGC Networks (India) (ITA No. 397/2015) in the context of explanation 6 to section 9(1)(vi) introduced in 2012 w.r.e.f. 1976 and Western Coalfields Ltd. (ITA No. 93/2008) in the context of retrospective amendment to section 17(2)(ii) to highlight the impossibility of discharging withholding obligation.

xxxix) Thus, the SC held that "person" mentioned in section 195 of the Act could not be expected to do the impossible i.e. to withhold taxes by applying the expanded definition of "royalty" inserted by explanation 4 to section 9(1)(vi) of the Act, at a time when such explanation was not actually and factually in the statute.

AAR/High Court decisions upheld/set aside by the SC

xl) The SC approved the decision of AAR in case of ***Dassault Systems, K.K., In Re., (2010) 322 ITR 125 (AAR)*** and ***Geoquest Systems B.V. Gevers Deynootweg, In Re., (2010) 327 ITR 1 (AAR) by*** observing that the AAR had correctly applied the principle that the ownership of copyright in a work was different from the ownership of the physical material in which the copyrighted work may happen to be embedded.

xli) Further the adverse decision of AAR in case of ***Citrix Systems Asia Pacific Ptyl. Ltd., In Re., (2012) 343 ITR 1 (AAR),*** was set aside as it did not state the law correctly, by observing as:

a. Under a non-exclusive license, an end-user only gets the right to use computer software in the form of a CD and does not get any of the rights that the owner continues to retain under section 14(b) of the Copyright Act read with sub-section (a)(i)-(vii) thereof.

b. The AAR had incorrectly held that it was not constrained by the definition of 'copyright' under the Copyright Act while construing the provisions of the DTAA, without appreciating that u/s 16 of the Copyright Act no person is entitled to copyright otherwise than under the provisions of the Copyright Act or any other law in force. The SC also observed that the expression "copyright" has to be understood in the context of the statute which deals with it, it being accepted that municipal laws which apply in the Contracting States must be applied unless there is any repugnancy to the terms of the DTAA.

xlii) Similarly, the SC held the Karnataka High Court in case of ***CIT vs. Samsung Electronics Co. Ltd., (2012) 345 ITR 494*** made the same error as done by the AAR in case of Citrix (supra) in as much as that no distinction was made between a computer software that was sold/licensed on a CD/other physical medium and the parting of copyright in respect of any of the rights or interest in any of the rights mentioned in sections 14(a) and 14(b) of the Copyright Act. In view of the same, the SC held that the payment for such computer software could not amount to royalty within the meaning of Article 12 of the DTAA or section 9(1)(vi) of the Income Tax Act.

xliii) The SC also held that the decision of ***CIT vs. Synopsis International Old Ltd., ITA Nos. 11-15/2008,*** did not state the law correctly. The SC held that:

a. the Karnataka High Court had observed that the expression "in respect of" (copyright) should be given a wider meaning i.e. "attributable" to the copyright and therefore consideration paid for transfer of a copyrighted article, would be taxable, though the right in the copyright is not transferred, since a right in respect of a copyright contained in the article is transferred and that any other interpretation would lead to the aforesaid provision becoming otiose. The SC by relying on the decision in case of ***State of Madras vs. Swastik Tobacco Factory, (1966) 3 SCR 79***, accepted that the expression "in respect of" should be given a wider meaning i.e. "attributable", however the SC rejected the conclusion arrived at by the Karnataka High Court by holding that even where such transfer is "in respect of" copyright, the transfer of all or any rights in relation to copyright is a sine qua non under explanation 2 to section 9(1)(vi) of the Act.

b. section 16 of the Copyright Act, which states that "no person shall be entitled to copyright…otherwise than under and in accordance with the provisions of this Act or of any other law for the time being in force" made it clear that the expression "copyright" had to be understood in terms of section 14 of the Copyright Act and not otherwise.

c. the HC was wholly incorrect in holding that the storage of a computer programme per se would constitute infringement of copyright, since it would directly be contrary to the provisions of section 52(1)(aa) of the Copyright Act.

d. the finding that when a copyrighted article was sold, the end-user gets the right to use the intellectual property rights embodied in the copyright which would therefore amount to transfer of an exclusive right of the copyright owner in the work, was wholly incorrect.

xliv) The SC approved the decision of Delhi High Court in case of ***DIT vs. Ericsson A.B. [2012] 343 ITR 470 (Del), DIT vs. Nokia Networks OY [2013] 358 ITR 259 (Del), DIT vs. Infrasoft Ltd. [2014] 264 CTR 329 (Del), CIT vs. ZTE Corporation [2017] 392 ITR 80 (Del),*** by observing:

a. Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts.

b. Copyright is an intangible, incorporeal right, in the nature of a privilege, which is quite independent of any material substance. Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied.

c. Parting with copyright entails parting with the right to do any of the acts mentioned in the Copyright Act.

d. The transfer of the material substance does not, of itself, serve to transfer the copyright therein. The transfer of the ownership of the physical substance, in which copyright subsists, gives the purchaser the right to do with it whatever he pleases, except the right to reproduce the same and issue it to the public. Thus, no copyright is parted.

e. The right to reproduce and the right to use computer software are distinct and separate rights.

f. The use of a copyrighted product cannot be construed as a license to enjoy all or any of the enumerated rights in the Copyright Act.

g. It would make no difference as to whether the end-user was enabled to use computer software that is customised to its specifications or otherwise.

xlv) The SC also held that *vide* Circular No. 10/2002 dated 09.10.2002, the Revenue itself has appreciated the difference between the payment of royalty and the supply/use of computer software in the form of goods, which would be then treated as business income of the assessee taxable in India if it has a PE in India.

Interpretation of the DTAAs in light of the Model commentaries and India's position/ reservations on the said commentaries.

xlvi) The SC, by placing reliance on the decision of ***Azadi Bachao Andolan (2004) 10 SCC 1,*** held that the DTAAs entered into between India and other Contracting States had to be interpreted liberally with a view to implement the true intention of the parties.

xlvii) The SC observed that the DTAAs under consideration had their staring point either from the OECD Model Tax Convention or the UN Model Convention, insofar as the taxation of royalty for parting with copyright was concerned. The definition of "royalties" under the concerned DTAAs were in a manner either identical with or similar to the definition contained in Article 12 of the OECD Model Commentary and therefore the same becomes relevant.

xlviii) The SC perused the OECD Model Commentary on Article 12, which supported the position that

a. There is a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program.

b. Making a copy or adaptation of a computer program to enable the use of the software for which it was supplied did not constitute royalty

c. Payment made by distributors and end users did not qualify as royalty.

xlix) Further, the SC also referred to the India's positions/reservations on the said OECD Model Commentary on Article 12 and observed that the said positions/ reservations were not clear/vague as contrasted with the categorical language used by India in its positions taken with respect to other aspects in Article 12.

l) Further, the SC also referred to the decision of Delhi High Court in case of ***Director of Income Tax vs. New Skies Satellite BV, (2016) 382 ITR 114*** wherein it was held that mere positions taken with respect to the OECD Commentary do not alter the DTAA's provisions, unless it were actually amended by way of bilateral re-negotiation.

li) Further, it was also observed that after India took such positions qua the OECD Model Commentary, no bilateral amendments were made by India and the other Contracting States to change the definition of royalties contained in any of the concerned DTAAs, in accordance with its position.

lii) The SC also observed that though India-Singapore DTAA and India-Mauritius DTAA were amended several times, however no changes in the definition of 'royalty' was made. Therefore, it was thus clear that the OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the concerned DTAAs had a persuasive value as to the interpretation of the term "royalties" contained therein.

liii) The SC also observed that the OECD Commentary would be significant for persons deducting tax/for assessees to conclude business transactions on the basis that they are to be taxed either on income by way of royalties for parting with copyright, or income derived from licence agreements which would be then taxed as business profits depending on the existence of a PE in the Contracting State.

liv) The SC also held that the HPC Report 2003 and the E-Commerce Report 2016 were recommendatory reports expressing the views of the committee members, which the Government of India may accept or reject and however, for the purpose of DTAA, a DTAA would have to be bilaterally amended before any such recommendation can become law in force for the purposes of the Act.

B. High Court

2 ***CIT vs. GE India Technology Centre (P.) Ltd. [2021] 125 taxmann.com 168 (Karnataka)***

When the rate of interest pertaining to ECB paid by the assessee to its AE was accepted by the Revenue in the previous assessment years as well as in subsequent assessment years, Revenue could not dispute the same for the impugned assessment year. Further approval given by the Reserve Bank of India with regard to rate of interest would be a relevant factor while determining the ALP of the rate of interest.

Facts

i) The assessee was engaged in the business of research and development in the area of material sciences and process technology and providing related software development services. During the course of assessment proceedings, the TPO recomputed the ALP of the interest paid/payable by the assessee on the ECB at the rate of 5.67% instead of 7.50% and 8.49% as calculated by the assessee and proposed TP adjustment to the tune of INR 104,96,20,245 The action of the TPO was upheld by the DRP.

ii) On appeal by the assessee, the Tribunal deleted the said TP adjustment by observing that since the interest was paid at the same rates on the basis of loan agreements entered into by the assessee during the AY 2000-01 and the same was accepted by the Revenue for AY 2002-03, 2003-04, 2004-05, 2005-06 and 2008-09, the same could not be disputed for the impugned year i.e. AY 2006-07. Further, the Tribunal also observed that the interest rates were approved by the Reserve Bank of India and that the approval given by the Reserve Bank of India with regard to the rate of interest was a relevant factor while determining the ALP.

iii) On appeal by the Revenue, the Karnataka HC held as under :

Decision

iv) Before the HC, the Revenue argued that the Reserve Bank of India, in order to regulate the foreign exchange, prescribes the minimum and maximum rate of interest payable on external commercial borrowings and the approval of the Reserve Bank of India does not determine the ALP of the interest rate between the related parties and therefore the rate of interest would be determined on the basis of the rate of interest applicable between the unrelated parties in terms of Rule 10B of the Income Tax Rules.

v) The HC observed that in the facts of the case, Reserve Bank of India had given the approval in respect of the rate of interest and the approval given by the Reserve Bank of India with regard to rate of interest was a relevant factor while determining the ALP of the rate of interest. Further, the HC also observed that the rate of interest should be determined on the basis of rate of interest prevailing at the time of availing the loan.

vi) The HC observed that the Tribunal had rightly held that the Revenue could not be allowed to make a departure, when the Revenue had accepted the rate of interest for the AY 2002-03, 2003-04, 2004-05, 2005-06 and AY 2008-09. The HC also referred to the decision of the Hon'ble Supreme Court in ***Radhasoami Satsang vs. CIT [1992] 60 Taxman 248/193 ITR 321 (SC)*** wherein it was held that even though principles of res judicata do not apply to income tax proceedings, but where a fundamental aspect permeating through the different AYs has been found as the fact one way or the other and the parties have allowed the position to be sustained by not challenging the order, it would not be at all appropriate to allow the position to be changed in subsequent year.

Note: In the aforesaid case, w.r.t deduction u/s 10A of the Act, the HC held that Telecommunication expenses and travelling expenses incurred by assessee in foreign currency which were reduced from export turnover were also to be reduced from total turnover for computing deduction under section 10A of the Act.

C. Tribunal

3 ***DCIT vs. Sisecam Flat Glass India Ltd. [TS-179-ITAT-2021(Kol)]***

Monitoring fees paid to a non-resident bank (towards servicing of loan, maintaining record of payments, collecting and making escrow payments, passing principal and interest payments details etc.) would fall within the definition of "interest" u/s 2(28A) of the Act as well as under Article 11(4) of the India-Germany DTAA and consequently the same would not be liable to tax under Article 11(3)(b) of the India-Germany DTAA

Facts

i) The assessee had obtained a loan facility from the Deutsche Investitions- und Entwicklungsgesellschaft (DEG) Bank, Germany and in terms of the loan agreement, the assessee, along with interest, was also required to pay monitoring fees to the Bank towards servicing of loan, maintaining record of payments, collecting and making escrow payments, passing principal and interest payments details etc.

ii) During the course of assessment proceedings, the AO held that 'interest' paid to DEG Bank was exempt from tax in India under the India-Germany DTAA (DTAA). However, w.r.t the monitoring fees paid pursuant to the loan agreement, the AO held that the same was not akin to 'interest' and was therefore liable to withholding tax u/s 195 of the Act. Consequently, he disallowed the payment of monitoring fees by invoking section 40(a)(i) of the Act.

iii) The CIT(A) decided in favour of assessee, by observing as follows:

a. Section 2(28A) of the Act, defines 'interest' in an inclusive manner to *inter alia* include within its purview 'any service fee or other charges" - (i) 'in respect of the monies borrowed', (ii) 'in respect of the debt incurred', (iii) 'in respect of any credit facility' or (iv) in respect of any credit, which has not been utilized'.

b. The expression 'service fee and other such charges' which are levied by the lender in the course of such loan inter alia includes processing, monitoring, managing, restructuring charges or fees etc. and therefore monitoring fees paid by the assessee falls within the scope of the said clause, and hence would be in nature of 'interest' u/s 2(28A) of the Act. Reliance in this regard was placed on the decision of ***Shimla Automobiles (P) Ltd. vs. ITO (164 ITD 9)*** and ***Chintamani Hatcheries (P) Ltd. vs. DCIT (75 ITD 116).***

c. Article 11(4) of the DTAA defines 'interest' to mean income from debt claim of any kind, meaning thereby any stream of income derived in any form by the lender, i.e. DEG Bank, which emanate from a debt claim would be in the nature of interest income. Therefore, the term 'interest' as defined in the DTAA is far wide enough and comprehensive than the definition of 'interest' u/s 2(28A) of the Act.

d. In the facts of the present case, the income by way of monitoring fees had arisen to DEG Bank from the loan agreement entered into with the assessee and therefore the same would be in nature of 'interest' as defined under Article 11(4) of the DTAA and thus would not be taxable under Article 11(3)(b) of the DTAA.

iv) The Revenue filed appeal before the Tribunal.

Decision

v) The Tribunal upheld the order of the CIT(A) by observing that monitoring fees paid by the assessee to DEG Bank, Germany qualified as 'interest' both under the Act as well as the DTAA and thus the payment made was not liable to tax under Article 11(3)(b) of the DTAA. Hence no deduction of tax at source was required to be made u/s 195 of the Act and consequently no disallowance u/s 40(a)(ia) of the Act could be made.

Note:

i. In the aforesaid case, the Tribunal also adjudicated the following issues:

a. With respect to loss on interest rate hedging – The Tribunal relied on co-ordinate bench ruling in case of Mcleod Russel India Ltd. (ITA Nos. 114 & 115/Ko1/2016) dated 03.05.2019 wherein it was held that the MTM loss incurred on currency interest rate arrangements with the bank was non-speculative in nature and deductible from the profits of the business. Accordingly, the Tribunal upheld the order of the CIT(A) deleting the disallowance.

b. With respect to the depreciation claim u/s 32 @ 25% on software – The Tribunal remanded the matter for a fresh adjudication.

D. Authority for Advance Rulings

4 ***Technip France SAS, In re [2021] 124 taxmann.com 389 (AAR - New Delhi) [02-02-2021]***

Under a composite contract, consideration received by F Co. for offshore supply of equipment to I Co. would not be chargeable to tax in India. However, consideration received for rendering basic engineering

design services w.r.t the construction, erection, installation, commissioning, testing of plant and advisory services in relation to the detailed engineering, through its PE, would be liable to tax in India as business income of the F Co.

Facts

FACTS

i) The applicant, a non-resident entity was engaged in Engineering, Procurement and Construction (EPC) business for oil production i.e. offshore and onshore refining, petrochemicals, fertilizers, chemicals, pharmaceuticals, non-conventional energy, sub-marine pipes, etc. An Indian company (I. Co) floated a tender to set-up a Plant on a turnkey basis inviting bids for designing, engineering and construction of the Plant at site. The applicant submitted a techno commercial offer and price proposals for execution of the scope of work mentioned in the tender floated by the I Co. Subsequently, the bid of the applicant was accepted by the I Co. and the contract was awarded to the applicant vide notification of award dated 15 April 2011 (NoA). However, the actual contract between the applicant and I Co was signed on 21 November 2011.

ii) The applicant's scope of work was divided into two parts i.e.

   a. the offshore scope of work – which included offshore supply of equipment, offshore services for basic engineering design in relation to setting up of the Plant site, assistance in detailed engineering and technology licensing and

   b. Onshore scope of work – which included onshore supply of equipment, third party inspection and onshore services for detailed engineering, procurement, construction, erection in relation to setting up of the Plant at site, start-up commissioning and post commissioning service.

iii) At the bid stage it was agreed that the applicant would undertake the offshore scope of work and its Indian subsidiary would undertake the onshore scope of work.

iv) The applicant sought an advance ruling from the Authority for Advance Ruling (AAR), on whether any part of the consideration received / receivable by the applicant from I Co for the following offshore work was liable to tax in India under the provisions of the IT Act and / or India- France tax treaty (DTAA) read with its protocol:

   a. Offshore supply of all equipment.

   b. Offshore basic engineering design services carried or to be carried out in France in relation to the construction, erection, installation, commissioning and testing of the plant in India.

   c. Offshore advisory services rendered or to be rendered from France in relation to detailed engineering to be done by the taxpayer's project office (PO) in India for setting up of plant at site.

v) The applicant had contended that consideration in respect of technology licensing services and inspection services were offered to tax and not subject matter of determination before the AAR.

vi) The AAR ruled as under:

Decision

Taxability of offshore supply

vii) The AAR observed that it was agreed in the contract that the ownership of offshore equipment and materials would be transferred to the I Co. upon FOB shipment for the imported supply. Though, the applicant was responsible for insurance of all the materials including cargo transit insurance as well as for transportation and safe storage of the equipment and materials to the contract site, these obligations had no impact on the transfer of ownership of the imported materials. Also the payment was made outside India and was remitted through electronic fund transfer to the contractor's bank account.

viii) The invoice and the bill of lading in respect of offshore supply was in the name of the I Co. and not in the name of the applicant or its agent. Therefore, the title to and property in the goods shipped by the applicant at the foreign port was transferred at the port of shipment itself. This event took place outside the territory of India and the income arising out of such sale transaction could not be said to have accrued or arisen in India. The AAR relied on the decision of Hon'ble Supreme Court in ***Mahabir Commercial Company Limited vs. CIT [1972] (86 ITR 417) (SC).***

ix) The AAR also observed that even if the goods were in the custody of the applicant for the purpose of erection and installation, I Co. had already became the owner of equipment and materials well before the goods had reached the Indian port. The condition that the performance guarantee tests were to be performed by the applicant, who would be responsible for the quality and satisfactory performance of the equipment, also could not be considered as a condition which postponed the transfer of title to the offshore equipment and material till that time. This stipulation was in the nature of warranty provision in the contract, and it could not be deemed that the transfer of title of the property had taken place in India on satisfactory performance guarantee test. The AAR relied on the decision of Supreme Court in case of ***Ishikawajma-Harima Heavy Industries Ltd. vs. DIT [2007] 158 ITR 259 (SC),*** wherein the Supreme Court had held that no part of profit arising from the offshore supply of equipment outside India would be chargeable to tax in India.

x) The AAR further held that the applicant's PE was not involved in offshore supply of equipment and materials. The entire requirement of imported components of supply was identified at the time of preparation of bid document itself and included in the contract document. It was not that the imported components of supply were identified in the course of execution of the contract and ordered at the instance of the PE. The principle of apportionment of income on the basis of territorial nexus was well accepted. Explanation 1(a) to Section 9(1)(i) stipulates that where all the operations are not carried out in India, only that part of income which can be reasonably attributed to the operations in India, would be deemed to accrue or arise in India. In a composite contract where only a part of the operations were to be carried out in India, the applicant would not be liable for part of income that arises from operations conducted outside India. In such a case, income from the contract has to be appropriately apportioned.

xi) Therefore, the income from off-shore supply of equipment were held to be not chargeable to tax in India, under the Act, as the sale was completed outside India and there was no accrual or deemed accrual in India.

Taxability of offshore service

xii) As per Article 13(4) of the DTAA payment of any kind in consideration for services of a managerial, technical or consultancy nature qualifies as FTS. The AAR observed that there was no doubt that the basic engineering design services and offshore advisory services rendered by the applicant were in the nature of FTS as per Article 13(4) of the DTAA.

xiii) However, by virtue of the MFN clause in the said DTAA, the applicant claimed the benefit of "make available" clause available in the India- Finland and India-Portugal DTAA. The AAR observed that the basic engineering design and detail engineering services, even if developed in France, were not final and could not have been rendered directly from France without the involvement of the PO in India and also without prior consultation with the I Co. Further, it was also contemplated in the Contract that I Co. would review all facets of design including design calculations in order to ascertain compliance with design criteria, specifications and conceptual design. These services enabled the recipient of these services to perform the same services, in the future, without recourse to the applicant. Thus, the condition of make available' of the services was held to be satisfied from the terms of the contract and therefore the reliance on the MFN clause in the Protocol to the DTAA was held to be redundant.

xiv) Further, the AAR held that in this process, the applicant was not only making available the design services to I Co. but the design, even if prepared in France, were not being rendered directly from France. Thus, the rendering of actual service was in India and not in France. Therefore, as the basic engineering design services and offshore advisory services were rendered in India and these services were also made available to I Co., they were taxable not only in accordance with the provisions of the Act but also under the DTAA.

Permanent Establishment and attribution of the offshore services to the PE in India

xv) The AAR observed that though the contract was signed on 21 November 2011, the effective date of contract was 15 April 2011. Even if the PO was set up after the effective date of contract, the applicant had the services of its Indian subsidiary at its command. The personnel of its subsidiary were involved in the bidding process of the applicant from the very beginning from the purchase of tender document, attending techno-commercial and price bid opening and bid clarificatory meetings, etc. Further, the deployment schedule of supervisory personnel for the contract as filed by the applicant had CVs of the key personnel and most of the key supervisory personnel were employees of Indian subsidiary. These employees not only had a secured right to use their office space, but they were carrying on the business of the parent enterprise i.e. applicant and in this sense the applicant had a fixed place of business. Therefore, the applicant had a PE from the effective date of contract.

xvi) The AAR observed that the basic engineering design services and offshore advisory services as rendered by the applicant were not stand-alone services but were intrinsically connected with setting up of Plant. The contract was not for these design services, but these were only small components of the turnkey contract. Further, the payment received by the applicant was for construction and erection at site within the territory of India and for performance of the contract as a whole in India. There was no exception in the contract for accrual of any part of the contract outside India except in respect of offshore supply of equipment and hence it indicated that the consideration paid to the applicant in respect of 'Basic Engineering' and 'Detailed Engineering' services had accrued in India.

xvii) Further, the engineering design had to be customised and prepared vis-a-vis the location of the site and taking into account the local factors and could not have been delivered exclusively from France. The involvement of the PE i.e. PO of the applicant in such designing process was inevitable. However, the service pertaining to construction, erection, installation, commissioning and testing of the plant could not have been rendered from France without the involvement of the PE in India. In fact, the applicant had also admitted in the application that all such engineering, drawings, designs, etc. would only be used by the PO of the applicant for setting up a Plant at site, I Co. would not be able to independently use the technology in the drawings, design documents, etc. Thus, even if the part of design services were developed in France, the actual rendering of the basic engineering design service as well as offshore advisory services was done not directly by the applicant from France but by its PO in India and thus same was found covered under Article 7 of the DTAA. As the services were inextricably connected with setting up of the plant and were rendered through this PE, the profit of the PE was thus required to be taxed in India as per the provision of Article 7(1) of the tax treaty in respect of these services.

■●■

Character has to be established through a thousand stumbles.

— *Swami Vivekananda*

You know but little of that which is within you. For behind you is the ocean of infinite power and blessedness.

— *Swami Vivekananda*

The remedy for weakness is not brooding over weakness, but thinking of strength.

— *Swami Vivekananda*