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International Tax- Judicial Decisions and Transfer Pricing -Notifications

In Brief

Purchase of computer software by Indian end-users or distributors from non-residents under End User License Agreements (EULA) or similar agreements, which do not result in transfer or use of copyright in software, is not liable to withholding tax in India under the DTAA

International Tax – Judicial Decisions

Engineering Analysis Centre of Excellence (P.) Ltd.
([2021] 125 taxmann.com 42 (SC))
(In favour of assessee)

Facts

The Karnataka High Court (HC) in a common judgement [reported as CIT v. Samsung Electronics Co. Ltd. ((2012) 345 ITR 494)] had held that the amounts paid by a resident Indian to a non-resident software supplier, were in the nature of "royalty" under the Income-tax Act, 1961 ('the Act'). Accordingly, the said payment was subject to withholding tax in India. The basic premise of the HC was that payment for purchase or use of computer software included a right or interest in a 'copyright' which resulted in taxable royalty income in India.

The said HC judgment was relied upon extensively by Indian tax authorities to raise withholding tax demands on Indian businesses making payment to non-residents for purchase or use of computer software. As this became a pan-India issue resulting in multiple appeals, the Supreme Court (SC) grouped the appeals, facts and issue of applicability of withholding tax on the payments towards:

i. Direct purchase of computer software by an Indian resident end-user.
ii. Purchase of computer software by an Indian resident for distributing/reselling in India including purchase from non-resident distributor/reseller.
iii. Purchase of computer software embedded in hardware sold as integrated unit by an Indian resident distributor/reseller/end-user

Held

<u>Whether sale of software is a transfer of copyright or use of copyright:</u>

The SC analyzed the meaning and definition of the term 'royalty' in the background of:

- the provisions of the Act read with relevant Indian tax treaties;
- OECD Model Commentary on tax treaties;
- various judgements
- Indian Copyright Act, 1957

and observed as under:

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- Copyright is an exclusive right, which is negative in nature i.e. it gives right to restrict others from doing certain acts;
- Copyright is in the nature of a privilege, independent of material substance. In other words, ownership of copyright in a work is different from the ownership of the physical material in which copyrighted work is embodied. For example, purchaser of a book does not become owner of copyright of the contents therein. It is akin to sale of goods rather than transfer of copyright. Essentially, there is a difference between copyright and copyrighted article.
- Transfer of a material substance containing the copyright by itself does not result in transfer of the copyright therein. To undertake such transfer, the recipient should be entitled to carry out certain acts mentioned in section 14 of the Copyright Act, 1957.
- Where the core of a transaction is to authorize the end-user to have access to, and make use of, the "licensed" computer software product over which the licensee has no exclusive rights, no copyright is parted with. It makes no difference whether the end-user is enabled to use computer software that is customised to its specifications or otherwise.
- A non-exclusive, non-transferable license, merely enabling the use of a copyrighted product are restrictive conditions ancillary to such use. This cannot be construed as a license to enjoy all or any of the rights mentioned in section 14 of the copyright Act.
- The right to reproduce and right to use the computer software are distinct and separate rights.

Based on the above observations, the SC concluded that:

- The definition of the term "royalty" was retrospectively expanded under the Act in 2012 to include payments for use of computer software. However, retrospective amendment cannot expect the payer to do the impossible which was not explicitly provided in the law.
- As long as the definition of 'royalty' as per relevant Indian tax treaty is beneficial, as compared to the definition of 'royalty' under the Act, the beneficial provisions of applicable tax treaty would apply.
- The above-mentioned payments for purchase of computer software from non-resident sellers / distributers cannot be taxed in India as "royalty" under the Indian tax treaties.
- In absence of any taxable presence / permanent establishment of the non-resident sellers / distributers in India, Indian withholding tax would not apply.

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CNK Comments

This is a landmark judgment of the SC which puts a long-contested issue and controversy to rest. The SC has meticulously analyzed each facet and argument of both parties and considered the substance of the transaction over its form. This judgment should assist taxpayers in their pending disputes on this issue with Indian tax authorities. Possibility of claiming refund of taxes based on this judgment can also be considered, subject to permissibility under the Act. Importantly, going forward, non-resident taxpayers seeking tax benefit in India under an applicable Indian tax should consider the impact of the Multilateral Instrument (MLI) on their transactions. Also, if their income is not royalty under the Act / tax treaty, the applicability of equalization levy (EL) on e-commerce operator in India should also be considered. This is because Finance Act, 2021 amended section 10(50) to clarify that online sale of goods or provision of services can be chargeable to EL only where the covered transaction is not taxable in India as Royalty or Fees for Technical Services under the Act read with the relevant Indian tax treaty.

No withholding of tax on reimbursement of expenses if "twin conditions" of one-to-one correlation between outflow and inflow; and identical amounts; are satisfied

BKY Asia Pacific Pte. Limited [TS-203-ITAT-2021 (PUN)]
(In favour of assessee)

Facts

Assessee company, a tax resident of Singapore (Singapore HO) had presence in several countries including a branch office in India (Indian BO). Indian BO was providing technical support services to the customers of its parent German entity without charging any service fee. The Singapore HO reimbursed all the expenses to Indian BO along with the mark up of 10%. The Indian BO treated itself as a PE of the Singapore company in India and offered the mark-up to income-tax.

During the year under consideration, Indian BO reimbursed certain expenses to Singapore HO without deduction of tax at source under section 195 of the Act and claimed deduction of the said expenses while computing taxable income. The Assessing Officer (AO) treated the said payment as fees for technical services on which tax should have been withheld and disallowed the said expenses on account of non-withholding of tax. The taxpayer filed objections before the Dispute Resolution Panel (DRP) but the same were reject and the disallowance was upheld. Accordingly, the taxpayer approached the Pune Tribunal.

Held

The Pune Tribunal observed that the expenses reimbursed by the Indian BO were in the nature of seminar, IT, training, printing and staff welfare. As the transactions between the Indian BO and the Singapore HO are to be considered as a transaction between two separate independent entities, the issue of withholding tax on the said reimbursement payment has to be considered. In this regard, two fundamental conditions must co-exist in order to fall within the domain of reimbursement i.e.,

i. one-to-one direct correlation between the outgo and inflow must be established;
ii. Receipt and payment must be of identical amount;

The above conditions get satisfied if:

- at stage of incurring expenses itself, it is known to be for the benefit of the other and not the payer.
- the receipt of the amount originally spent is without any mark-up i.e. amount equal to the exact amount of expense incurred is recovered. However, receipt of a fixed amount, which may be more or less than the actual outgo, cannot be designated as `reimbursement'.

Based on facts of the case and documentary evidence submitted, the expenses reimbursed by Indian BO satisfied both the aforesaid conditions. Accordingly, Indian BO was not required to withhold any tax at source on the payment made to Singapore BO for reimbursement of expenses.

CNK Comments

This judgment emphasizes the fact that in order to treat a payment as reimbursement, the payer needs to obtain and maintain robust documentation to demonstrate that expenses are incurred for its benefit and are charged to it without mark-up. If there is any gap in amount reimbursed and amount incurred by overseas entity, the position of reimbursement may be lost and Indian tax implications could arise. Interestingly, the Tribunal has permitted full deduction for transactions with HO in nature of reimbursement (while technically being with self / same legal entity). Hence, this judgment may be relevant for BOs of foreign companies operating in India and facing difficulty in claim of HO expenses.

In Brief

Commission income of non-resident agent for services rendered and utilized outside India not taxable in India

Puma Sports India P. Ltd. [TS- 221-HC-2021 (KAR)]
(In favour of assessee)

Facts

The assessee, is a trader of sports gear. It purchased goods from related and unrelated foreign parties as well as from the local manufacturers. The Associated Enterprises (AE) sourced goods for the assessee and rendered services outside India in the form of placing the orders with manufacturers. For this, assessee paid commission to its AE outside India without withholding tax as the services were rendered outside India and also not utilized in India. However, the AO disallowed the said commission payment on the ground that the income arose in India and hence, taxpayer ought to have withheld appropriate tax. The case was litigated before the Tribunal, wherein the tribunal upheld the assessee's stand. Aggrieved, the tax department filed an appeal in the Karnataka High Court.

Held

The Karnataka High Court observed that:

- The commission became payable / accrued when services were rendered in the form of placing orders with the manufacturers outside India. The services were not rendered in India. Accordingly, the income did not accrue or arise in India.
- The decision of SC in case of GVK Industries Ltd. (371 SC ITR 453) relied upon by the tax department was distinguishable on facts as in that case payment was made for consultancy fees which are deemed to accrue and arise in India as "fees for technical services" (FTS). In the current case, the payment was not FTS but commission.
- In fact, the HC relied on the decision of SC in case of Toshuku Ltd. (1980 (Supp). SCC 614), wherein it was held that if no operations of business are carried out by non-resident agent in India, the said income does not accrue or arise in India and cannot be deemed to accrue or arise in India.

Based on above, the HC held that:

- The AE had rendered services out of India in the form of placing orders with the manufacturers who were already outside India and the commission was paid to AE outside India;
- Therefore, no taxing event had taken place within the territories of India and therefore, the requirement to withhold tax on the said commission or disallow the expense for non-withholding of tax did not arise.

CNK Comments

This decision will help underline the position that commission paid outside India to non-resident agents for services rendered outside India continues to be not liable to withholding tax in India. In light of the recent decision on virtual and intangible business of non-residents creating taxable presence in India, it would be advisable to maintain robust documentation to substantiate that no part of the non-resident agent's services are rendered in India.

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In Brief

Amendments in rules relating to Country-by-Country report (CbCR) and Master File compliance

Transfer Pricing - Notification

Notification No. 31/2021/F.No.370142/19/2019-TPL dated 5 April 2021

Amendment in Rule 10DA – Constituent entities 'non-resident' in India not required to separately file master file if compliance undertaken by resident Indian constituent entity

Earlier, where there were more than one constituent entities "resident" in India; one designated constituent entity "resident" in India could submit the Master File in Form 3CEAA (Part A and/or Part B) on behalf of the international group. Resultantly, non-resident constituent entities of the same international group were required to file separate master file with essentially the same information (data/details/etc.).

With effect from 1 April 2021, the rule has been amended to permit any designated constituent entity of international group to file the master file on behalf of its international group. Accordingly, a non-resident constituent entity would now not be required to separately file the master file if another designated resident constituent entity has filed the master file on its behalf.

CNK Comments

This is a welcome move by the CBDT as this will reduce/eliminate the duplication of compliance/data relating to master file of an international group.

Amendment in Rule 10DB – Consolidated group revenue threshold for CbCR compliance increased from INR 5,500 crores to INR 6,400 crores

Earlier, only an international group with total consolidated group revenue (as per consolidated financial statements of the preceding accounting year) exceeding INR 5,500 crores was required to file the CbCR. With effect from 1 April 2021, the said group revenue threshold has been increased to INR 6,400 crores.

CNK Comments

While the increase in threshold may reduce the number of Indian international groups which may be required to file CbCR, the impact on applicability of CbCR compliance in India to non-Indian international groups will need to be checked in light of depreciation of the Indian rupee.

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