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Judicial Decisions-International Tax and Transfer Pricing

International Tax

Receipts towards sale of software license and related support services is not taxable as 'Royalty' under the India-Singapore tax treaty

BMC Software Asia Pacific Pte Ltd [TS – 861 – ITAT -2021 (Pun)]
(in favor of assessee)

Facts/Background:
Assessee, a Singapore based company earned income from sale of software licenses and income from support, maintenance and training services rendered in relation to such software licenses sold either directly or indirectly through third parties in India. The assessee did not file tax return in India on the ground that the said income was not taxable in India.

The case of the assessee was selected for scrutiny through provisions of reassessment i.e., provisions which permit assessment in cases where tax return has not been filed and taxable income has escaped assessment. The assessee submitted that it was not the owner of the software licenses and was only permitted to distribute such software licenses in Asia pacific region and the income from India was not taxable in India.

However, the Assessing Officer (AO) relying on various decisions including a High Court decision held that the income of the assessee from India was taxable as 'Royalty' under the Income-tax Act as well as the India – Singapore tax treaty.

Aggrieved by the order of AO, the assessee filed objections before the Dispute Resolution Panel (DRP). However, the DRP upheld the order passed by the AO.

Assessee therefore approached the Tribunal challenging the order of the AO and DRP on the ground that its income was not taxable in India.

Held:

It was an undisputed fact that the nature of receipts which assessee earned was from sale of software licenses and income from support, maintenance and training services rendered in relation to sale of such software licenses. Further, the receipts were not towards parting with the copyright of the software.

As the assessee was tax resident of Singapore, taxability of its income from India as royalty would depend on definition of royalty under the India – Singapore tax treaty (being more beneficial to its case).

As per the India – Singapore tax treaty, royalty means consideration for use or right to use any copyright of a literary, artistic or scientific work etc. Reliance can be placed on the binding judgment of the Supreme Court in Engineering Analysis Centre of Excellence Pvt. Ltd. vs CIT [(2021) 432 ITR 472 (SC)], wherein the Supreme Court held that:

a. 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.
b. Where the 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.

Since the facts of the present case were similar to those considered by the above-mentioned Supreme Court judgment, the receipt of the assessee was not taxable as royalty under Article 12 of the India – Singapore tax treaty. Resultantly, the income of the assessee was business income which was not taxable in India in absence of its permanent establishment (PE) in India.

CNK Comments:

Taxation of software payments as royalty has been a highly debated and litigated topic in India. Based on the landmark Supreme Court judgment in case of Engineering Analysis Centre of Excellence Pvt. Ltd., the view that seems to be emerging is that unless the payment can be said to be parting with the copyright in the software, the said payment would not be taxable as royalty under a beneficially worded Indian tax treaty. It may however be noted that payments towards purchase or use of software may be considered as royalty under the domestic Indian tax law. Hence, any assessee wishing to claim tax exemption / benefit under an applicable Indian tax treaty not only needs to maintain and furnish tax residency certificate (TRC) from its country of residence but also file a tax return in India explaining this position. Any tax treaty claim in India should be tested in light of the general anti-avoidance rule (GAAR) and principal purpose test (PPT) under the Multilateral Instrument (MLI), as applicable.

Re-domiciliation of an entity cannot by itself be the ground for denying tax treaty benefit

Asia Today Limited [TS – 620-ITAT-2021 (Mum)]
(in favor of assessee)

Facts/Background:

Assessee company was originally registered on 15 November 1991 in British Virgin Islands (BVI), as an international business company. On 29 June 1998, the assessee company re-domiciled itself in Mauritius.

The Mauritius authorities issued it a certificate of incorporation by continuation stating that:
"……Asia Today Limited in on and from 29th day of June 1998, incorporated by continuation as a private company limited by shares
….
this certificate will be effective on the date of deregistration of the company in its place of incorporation".

On 30 June 1998, the BVI authorities noted the assessee company's discontinuation of operations in BVI and issued a certificate stating that:
"The Registrar of Companies of the British Virgin Islands hereby certifies that
Asia Today Limited, an international business company incorporated under section 3 of the International Business Companies Act of the law of British Virgin Islands has discontinued its operations in the British Virgin Islands on 30th June 1998."

Thereafter, the assessee company was issued Tax Residency Certificate (TRC) by the Mauritius tax authorities on 6 July 1999.

During the years under consideration, the assessee company claimed the benefit of India – Mauritius tax treaty in India. However, the AO denied the said benefit on the ground that the assessee company was originally a BVI company, hence it was not entitled to claim benefits of India – Mauritius tax treaty merely by its re-domicile to Mauritius.

Held:

Corporate re-domiciliation, also referred to as 'Continuation', is the process by which a company moves its 'domicile' (or place of incorporation) from one jurisdiction to another by changing the country under whose laws, it is registered or incorporated, whilst maintaining the same legal identity.

There are various reasons and justifications for such re-domiciliation i.e., due to business, and even legal, position being rather dynamic and constantly evolving. These offshore entities sometimes are faced with a situation where the rules and regulations then prevailing in the current "domicile" (place of incorporation) of the company no longer fit the company's purpose. At times, the prevailing rules and regulations of its current jurisdiction of domiciliation may in some way inhibit its future business or prospects. For these and many other reasons, transferring the domicile of a company from one country to another may be the preferred option.

To effect a re-domiciliation, both the existing jurisdiction (where the company is currently registered) and the target jurisdiction (where the company is to be 'continued') need to be on the list of countries where re-domiciliation is possible. Both BVI and Mauritius are such jurisdictions. Legislation enacted expressly by these jurisdictions essentially provide that the company ceases to "live" in one jurisdiction, and is deregistered there, but via a transfer by way of the continuation process, is alive and well in another.

Given the ground realities of offshore world, re-naming, re-structuring and even re-domiciliation of offshore companies are facts of life. A re-domiciliation of the company by itself cannot lead to denial of treaty entitlements of the jurisdiction in which the company is re-domiciled. The same could however trigger a detailed examination of the re-domiciled company being actually fiscally domiciled in that jurisdiction.

From the facts available on record, it transpired that assessee company was originally incorporated in the BVI and stands migrated to /"re-domiciled" in, Mauritius. Since the re-domicile was completed almost 2 decades back, raising an issue of denying tax treaty benefit for this reason without any material on record was not justified.

CNK Comments:

This decision throws much needed light on the concept of re-domicile and availability of tax treaty benefits to a re-domiciled company in India. The Tribunal decided this case in favour of the assessee based on facts such as the re-domicile was 2 decades old and there was commercial justification for re-domicile. Going forward, any potential re-domicile should not only be supported by convincing business and economic reasons but also should clearly demonstrate that the same is not done with the principal purpose or one of the principal purposes of claiming tax treaty benefits in India. If this aspect is overlooked, then the possibility of the tax treaty benefit being denied under GAAR or PPT test (as applicable) cannot be ruled out.

Advertisement charges paid to Facebook Ireland (prior to introduction of Equalization Leavy) is not taxable as 'Royalty' under the India-Ireland tax treaty

Myntra Designs Pvt. Ltd [TS-833-ITAT-2021(Bang)]
(in favour of assessee)

Facts/Background:

Assessee, an Indian company made payment to an Ireland company of Facebook group towards advertisement charges without deducting tax at source. The assessee was of the view that:

a. Payment was made outside India and the Ireland company did not carry out any of the activities in India (they were wholly carried on outside India). Accordingly, there was no business connection in India and therefore payment made to said foreign company would not be income deemed to accrue or arise in India.
b. Payment made to Ireland company was towards the services rendered for uploading and display of the banner advertisement of the assessee company on its portal. Banner advertisement hosting did not involve use or right to use by the assessee company any Industrial, Commercial or Scientific equipment and no such use was actually granted by foreign company to the assessee Company.
c. Service rendered by Ireland company was a wholly automated process and there is no human touch at all in the services rendered which provide these advertising opportunities. Hence, the services (rendered without human touch) would not qualify as fees for technical services (FTS).

However, the AO disregarded the submissions/contentions of the assessee and noted that:

a. Ireland company provided many options to the businesses/advertisers to reach its database of users. The assessee company could choose their target market based on the age group, location, gender etc.
b. Unlike traditional advertising, the advertisement made on the Facebook platform was dynamic, highly target group specific and real time monitored advertising.

c. Assessee company could target specific groups and monitor the conversions or the success of the advertisements.
d. The platform also offered to:
    - monitor and evaluate the overall effectiveness of the ad campaign,
    - study the market behavior with respect to the products of various range,
    - to generate a wealth of actionable data using tools of business analytics,
    - to make commercially best decisions with regard to the ad campaigns and new product launches,
    - to design new products and launch them selectively in the most potential markets,
    - to analyze the consumer purchase pattern; and
    - to derive the maximum return on investments.
e. It was evident that the advertisements on the platform of the foreign company were nothing but the usage of foreign company's technology and process to advance the business in the e-commerce era and could not be equated with regular ad campaigns or banner services.
f. The technology, design, process and equipment of foreign company were being used, in a complex manner, with very high efficiency levels, to reach out to the target audience, within a fraction of the second of the target user logging in his/her account.

The AO therefore held that the above said payments are taxable in India primarily as 'royalty' and alternative as FTS / Fees for Included Services (FIS). Hence, that assessee company ought to have withheld tax u/s 195 while making payment to foreign company.

CIT(A) also upheld the order of the AO that the said payments were taxable in India as royalty.

Aggrieved by the same, the assessee company filed an appeal with the Tribunal.

Held:

The present case is identical to the facts of the Urban Ladder Home Décor Solutions P. Ltd. IT(IT)A No.615 to 620/ Bang/2020 wherein the Bangalore Tribunal, after detailed analysis of technical documentation and process-flows, held that:

a. On perusal of the agreements entered into with the non-resident entities, non-resident entities allowed assessee to use facilities provided in their sites which include, inter alia, software facilities.
b. The purpose of compelling the assessee to use those facilities, is to create an environment of ease in creating the advertisement content to suit Facebook platform.
c. An environment of ease is beneficial and time saving to both the advertiser and the advertising platform, and the facilities were created for mutual benefit. Further, the use of facilities is intertwined with the activity of placing advertisements on the web portal of non-resident or sending bulk mails.
d. The non-resident entities only allowed the use of their facilities to assessee for the purpose of creating advertisement content.
e. Non-resident entities did not give any specific license for use or right to any of the facilities (which include software) and those facilities are not for use in assessee's business.
f. The question of transferring the copyright over those facilities does not arise at all and the agreements perused also make it clear that the copyright over those facilitating software is not shared with the assessee.

f. The question of transferring the copyright over those facilities does not arise at all and the agreements perused also make it clear that the copyright over those facilitating software is not shared with the assessee.
g. In view of the foregoing discussions, the payments made by the assessee to Facebook (amongst others) cannot be considered as "royalty payments" which are taxable in India.

Relying on the aforesaid rationale the Tribunal in the instant case held that payments made to Ireland company of Facebook group for advertisement charges were not 'royalty' taxable income in India. Therefore, the assessee was not liable to deduct tax at source u/s 195.

CNK Comments:

The judgment explains the intricacies involved while analysing whether a payment towards a digital service is for a service or use of facility or use of software. It also highlights the need to understand the technical processes behind the digital service before concluding on its classification and taxability.

It may however be noted that this judgment pertains to a period before provision of digital advertisement services (similar to that of Facebook) were brought under the ambit of Equalization Leavy (EL) from 2016 onwards. Hence, for any similar payments made on or after 1 June 2016, the paying business (based in India) needs to deduct 6% EL from the said payment. Correspondingly, the amount subjected to EL is exempt from tax in India in the hands of the foreign company.

Transfer Pricing

Actual work performed determines characterization as a low-end or high-end service provider and not merely scope of work as per agreement or qualifications of employees

(Mindcrest India Pvt. Ltd. – TS-433-ITAT-2021 (Mum) – TP)
(in favor of assessee)

Facts/Background:

The assessee was providing offshore support services to its parent entity (AE). The said services were utilized by the AE for the use of its clients. For rendering the said services, the assessee had also entered into a service agreement with its AE which had a broad scope of work.

During the year under consideration, the AE had entered into an agreement with Bloomberg for researching keywords and phrases provided by Bloomberg using judgments / decisions / case laws of the United States of America (USA) including regulations, legislative and administrative materials. It was further agreed that the AE shall create a list of extracted information from these sources that best explain and define the keywords and phrases.

During the year under consideration, the assessee provided services to AE in respect of the Bloomberg contract by uploading the generic USA judgements on the given website. For this, the necessary infrastructure required was provided by the AE. The assessee's task was restricted to giving "treatment values" i.e., classification to the case laws of the USA Courts with respect to 'cited / discussed / criticized / distinguished / followed'. Therefore, the assessee employed law graduates to provide the services to the AE.

Since the assessee had employed law graduates, the Transfer Pricing Officer (TPO) was of the view that the assessee was engaged in legal process outsourcing which is a high-end service akin to Knowledge Process Outsourcing (KPO). Thus, TPO made upward adjustment to assessee's taxable income.

The CIT(A) also confirmed the action of the TPO that the services rendered by the assessee to its AE is that of high-level knowledge process services.

Aggrieved by the order of CIT(A), the assessee filed an appeal before the Tribunal.

Held:

From the documents available on record, it transpired that the service rendered by the assessee to its AE involved and was restricted to giving "treatment values" i.e., classification to the case law of the USA Courts with respect to "cited / discussed / criticized / distinguished / followed".

Though the service agreement between assessee and its AE contained a lot of services what is relevant to be seen is the actual services rendered by the assessee. The services even though performed by law graduates, did not involve any analytical skill and thereby were low end services. The Tribunal in one of the earlier years and even the tax authorities in subsequent years has accepted that the services provided by the assessee was low end.

Hence, the Tribunal was inclined to accept the type of services provided by the assessee at low end and allow the appeal of the assessee.

CNK Comments:

The rationale of the above decision is that in order to determine whether an assessee is engaged in high-end or low-end activity, it is important to consider the actual services rendered by the assessee; rather than make presumptions based on scope of work as per agreement or the qualification of the employees. Having said that, it is important to maintain and furnish robust documentation during assessment and appellate proceedings to convincingly explain the facts and support the transfer pricing policy of the assessee.

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