KPMG

TAX FLASH NEWS

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Payment for intranet charges and SAP software is royalty under the Income-tax Act as well as under the India-Germany tax treaty

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of SMS Iron Technology Pvt Ltd[1] (the taxpayer) held that payment made by the taxpayer to a non-resident company for software is covered under the term 'scientific equipment' and therefore taxable as royalty under the Income-tax Act, 1961 (the Act) as well as under the India-Germany tax treaty (tax treaty). The Tribunal observed that the payments were made for the use of licensed software on the internet/intranet and it is also contingent on the basis of a number of user license or number of sessions for which the software is used.

The Tribunal held that the payment made by the taxpayer to a non-resident company for software cannot be termed as reimbursement of expenditure since the taxpayer has not produced any agreement, debit notes or working of such reimbursement. The Tribunal observed that when an Indian subsidiary company incurs expenditure or avails any service from some third party abroad and payment to such third party is routed through its holding or related company abroad, provision for deduction of tax at source apply as if taxpayer has made payment to such independent party de hors routing of payment through holding company.

Facts of the case

- The taxpayer is a subsidiary of a German company, engaged in the business of supply of assemblies/sub-assemblies of metallurgical equipment, provisions of consultancy and technical services in design and engineering to ferrous and non-ferrous sectors.
- During the Financial Years (FYs) 1999-2000 to 2005-06, the taxpayer has made payment to its parent company towards internet charges, payment for SAP software, etc., in Germany without deduction of tax at source under Section 195 of the Act. During the FY 2004-05, the Assessing Officer (AO) noticed that the taxpayer has remitted money to its parent company without deduction of tax and therefore, the enquiry was made.
- The taxpayer claimed that payments to group concerns are in the nature of reimbursement of expenditure and hence the concept of mutuality applies. Accordingly, no tax was required to be deducted thereon.
- The AO held that payments to parent company on account of internet charges, SAP software, etc., constitute royalty under Section 9(1)(vi) of the Act and it has deemed to accrue or arise in India under Section 5(2) of the Act. Further, the payment is chargeable to tax as 'royalty' under Article 12(3) of the tax treaty. Therefore, the tax should have been deducted under Section 195 of the Act thereon. Subsequently, the AO initiated Tax Deducted at Source (TDS) proceedings under Section 201(1)/201(1A) of the Act.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal's decision

Payment of SAP charges and intranet charges

- The taxpayer relied on Dispute Resolution Panel (DRP) order contending that payment of SAP charges and intranet charges is not chargeable to tax in India. However, the Tribunal in the present

[1] SMS Iron Technology Pvt. Ltd v. ITO (ITA No. 4480 to 4486/Del/2014) – Taxsutra.com

case observed that the DRP has not examined whether the agreement pertaining to the payment of these charges was for the actual cost incurred or merely crossed charged facilities. Further, the agreement for such payments has never been produced before the lower authorities as well as before the Tribunal. In view of this, the reliance on the decision of the DRP does not serve any purpose. Consequently, the decisions relied on by the taxpayer do not apply to the facts of the present case in the absence of any document produced by the taxpayer showing the agreement and the terms of such expenditure as well as the details of reimbursement of the expenditure made by the taxpayer.

- The decisions[2] relied on by the taxpayer are distinguishable on the facts of the present case. The Tribunal observed that in the case of Infrasoft, the issue before the Delhi High Court was that whether the amount received by the taxpayer, a non-resident company, for granting license to use its copyrighted software for licenses own business purpose only and it could not be brought to tax as 'royalty' under Article 12(3) of India-U.S. tax treaty. However, in the present case, the license of the copyrighted software of the parent of the taxpayer is not given to the taxpayer for use of its own business. It is a payment made for use of SAP software which was customised for the group concern. Further, intranet charges paid are also not a copyrighted article. The taxpayer has also not given any agreement that what kind of software, the taxpayer was using, hence, the benefit of the above decisions cannot be given to the taxpayer.

- The payment of SAP charges are made for use of licensed software on the internet/intranet and payment is also contingent on the basis of a number of the user license or number of sessions for which the software is used. In the present case, the technical support would also be provided by SAP, a German company and not by the recipient of the expenditure. In view of this, the above software receipt is for scientific equipment under the Act and the tax treaty. Hence, such payment is correctly regarded as royalty by the lower authorities under Article 12 of the tax treaty. In view of this, the payment made by the taxpayer to its holding company is chargeable to tax as royalty under the Act as well as tax treaty.

- Therefore, the taxpayer should have deducted tax at source under the provisions of Section 195 of the Act at the beneficial rate of 10 per cent provided under the tax treaty. In view of this, the order passed by the AO under Section 201/201(1A) for FY 2001-2002 to 2005-2006 are correctly confirmed by the CIT(A). Hence, the appeal of the taxpayer with respect to the FY 2001-2002 to 2005-2006 was dismissed.

[2] DCIT v. KPMG [2017] 164 ITD 421 (Mum), DIT v. Infrasoft Ltd [2014] 264 CTR 329 (Del)

Reimbursement of expenditure

- The taxpayer has not filed the copies of all agreements, in contracts in pursuance to which payments for SAP and intranet charges were made. Unless the taxpayer produces the agreement, it is not possible to accept that the payments are merely reimbursement for the expenditure. Further, the taxpayer has also not produced any debit notes or working of such reimbursement before the Tribunal also. In the absence of basic details that the amount of expenditure incurred by the taxpayer and paid to its Associated Enterprise (AE) is only reimbursement of expenditure, arguments of the taxpayer cannot be accepted.

- If the taxpayer would like to have the benefit of various decisions[3] it is the duty of the taxpayer to make proper claim thereof by producing what was the original cost incurred by the recipient of the income globally and how the expenditure have been allocated to the taxpayer substantiated by agreements. If the expenditure is incurred by the taxpayer and same were paid by the AE on the basis of the actual charges pertaining to the taxpayer, then only it can qualify as a reimbursement of expenditure.

- When Indian subsidiary company incurs expenditure or avails any service from some third party abroad and payment to such third party is routed through its holding or related company abroad, provision for deduction of tax at source apply as if the taxpayer has made payment to such independent party de hors routing of payment through holding company.

- The remission of the amount to the holding or related company for finally making payment to the third person will be considered as a payment to the third party. It cannot be termed as reimbursement of expenditure to the holding company. If the contention of the taxpayer is accepted and the payment to the third party, routed through its holding co. is considered as a reimbursement of expenditure to the related party, then probably all the relevant provisions in this regard will become redundant. Hence, the Tribunal rejected the argument of the taxpayer that it is merely a reimbursement of expenditure.

[3] DIT v. A P Moller Maersk AS [2017] 392 ITR 186 (SC), Sriram Refrigeration Industries v. ITO [2014] 361 ITR 119 (AP), DCIT v. KPMG [2017] 164 ITD 421 (Mum)

TDS proceedings for FY 1999-2000 and 2000-01

- The Delhi High Court in the case of NHK Japan Broadcasting Corporation[4] held that where no limitation is prescribed in Section 201 of the Act, then action must be initiated within the period of four years. However, in the present case the notice issued on 1 March 2006 can cover only the period of four years preceding that year.
- In the present case the FYs are 1999-2000 to 2005-06, therefore, the AO cannot assume jurisdiction for FY 1999- 2000 and 2000-01 accordingly, the AO cannot work out the short deduction of tax on SAP maintenance expenditure for FY 2000-01. Accordingly, following the decision of the Delhi High Court, the Tribunal in the present case held that the taxpayer should not be treated as an 'assessee in default' under Section 201(1) as well as not to charge interest consequently, under Section 201(1A) of the Act for these two financial years. Accordingly, the orders passed under Section 201(1)/201(1A) for FY 1999-2000 and 2000-01, consequent tax and interest thereon covered in the order for these two years are cancelled.

Our comments

The issue with respect to the taxation of payments made for software in the case non-residents has been a subject matter of debate before the Courts/Tribunal. Similarly, the issue of reimbursement and its withholding tax treatment has also been a subject matter of litigation before the Courts/Tribunal.

The Karnataka High Court in the case of CGI Information Systems & Management Consultants (P.) Ltd.[5] held that the payment made for a license to use intranet facilities provided by a non-resident amounted to 'royalty' taxable in India. The non-resident is the absolute owner of the intellectual property, and it is making available the said facility to its group company allowing them to use the facility, and the taxpayer has to pay the cost. Though they have paid the cost and some right in that is assigned to them, they cannot sell, license or lease that right. Therefore, it is clear that the cost is paid for using the computer software. When the taxpayer is allowed to use the said facility, it is nothing but a license to use the said facility.

The Tribunal in the present case has held that the payment made by the taxpayer to a non-resident is for scientific equipment and it is taxable as royalty under the Act as well as the tax treaty.

The Tribunal also held that the payment made by the taxpayer cannot be termed as reimbursement of expenditure since the taxpayer has not produced any agreement, debit notes or working of such reimbursement. It may be noted that reimbursements should be backed up by third-party documentation, i.e., an agreement, debit note, etc., and it should be substantiated that the expenditure is that of the payer which is being reimbursed to the payee. Depending upon the facts of each case, the taxpayer may avail an option to obtain a nil withholding from the tax authority.

[4] CIT v. NHK Japan Broadcasting Corporation [2008] 305 ITR 137 (Del)
[5] CIT v. CGI Information Systems & Management Consultants (P.) Ltd [2014] 48 taxmann.com 264 (Kar)

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