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TAX FLASH NEWS

5 April 2018

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Reimbursement of lease line charges having no income element is not taxable in India. Amendment in the Income-tax Act does not apply to the provisions of India-U.S. tax treaty

Background

Recently, the Pune Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of T3 Energy Services India Pvt. Ltd[1] (the taxpayer) held that reimbursement of expenditure (i.e., lease line charges) by the taxpayer to its US parent company do not include any income element and therefore the same is not subject to tax in India. The expenditure allocated by a U.S. company to the taxpayer was charged on the cost to cost basis. Hence, it cannot be said that there was any income element which has arisen and consequently, there was no requirement to deduct any tax on such payments.

The Tribunal held that though the definition of 'royalty' under the Income-tax Act, 1961 (the Act) had been amended, the term 'royalty' under the India-U.S. tax treaty (tax treaty) is not amended. In the absence of the same, the Tribunal held that in view of the definition of 'royalty' under the tax treaty, the taxpayer is not liable to deduct tax on the payments made to its parent company on account of lease line charges. The Tribunal held that the unilateral amendment in Section 9(1)(vi) of the Act to the term 'royalty' cannot be extended to the meaning of the term defined under the tax treaty. Where the provisions of tax treaty override the provisions of the Act and the definition of 'royalty' not having undergone any amendment in the tax treaty, the taxpayer was not liable to deduct tax on the payment of lease line charges.

Facts of the case

- The taxpayer is engaged in the manufacturing of industrial valves and valve components which were mainly used in oil field service industry. The U.S. parent company of the taxpayer had entered into an agreement with service provider i.e. Qwest Communications Inc for providing of bandwidth services against stated consideration. The said agreement is a contract for providing bandwidth services between the parent company and Qwest Communications Inc and the parent company in turn, provided bandwidth services to its subsidiaries against reimbursement of lease line charges.
- During the year under consideration, the taxpayer had paid lease line charges to its AE without deduction tax at source. The taxpayer claimed that the said expenditure was reimbursement of expenditure, having no profit element embedded in it and hence tax was not deductible on the same. The taxpayer also pointed out that lease line/bandwidth charges were not royalty for the use of process and it should not be considered so. Hence, TDS provisions under Section 195 of the Act was not applicable.

[1] T3 Energy Services India Pvt. Ltd v. JCIT (ITA No. 826/Pun/2015) – Taxsutra.com

- The Assessing Officer (AO) held that lease line charges were not reimbursement of expenditure to the AE for any services provided by them to the taxpayer. It was the payment made to the third party, i.e., Qwest Communication Inc, through AE of the taxpayer. The said payment was for providing lease lines for communication purposes. Thus, the amount remitted to the third party was income in its hands for the services provided. Hence, it was hit by provisions of Section 195 of the Act. The AO made reference to the amendment in the definition of 'royalty' under Section 9 of the Act with retrospective effect, to point out that the intention of Legislature in this regard was clear and explicit. It was pointed out by the AO that reason behind the amendment of the definition of 'royalty' was in the wake of various conflicting decisions on the issue of deduction of tax under Section 194J/195 of the Act on payment of lease line charges. The AO held that the provisions of Section 40(a)(i) of the Act would apply to all payments made during the year, irrespective of the year in which such tax was deductible.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal's decision

Withholding of tax

- The basic principle is that where reimbursement of expenditure does not include any income element, then the same is not subject to tax in India. In the present case, Qwest Communications Inc had raised charges on US parent company, and the portion allocable to the taxpayer was charged on the cost to cost basis. Hence, it cannot be said that there was any income element which has arisen in the case and consequently, it has been held that where the taxpayer had reimbursed the expenditure having no income element, there is no requirement to deduct tax out of such payments.
- The Tribunal has already decided this issue and held that under the provisions of a tax treaty, the term 'royalty' is defined and it does not cover any such services availed and payment made. In any case, the privity of contract is between Qwest Communications Inc, the service provider and US parent company who in turn had received bandwidth and passed on the services to various entities of the group on the cost to cast basis.
- The taxpayer as the recipient of services had reimbursed the same, and in the absence of profit/income element, there is no liability to deduct tax at source. Hence, the taxpayer cannot be held to be in default. It has been held that there is no merit in invoking the provisions of Section 40(a)(i) of the Act.

Taxability of royalty by virtue of amendment in the Act

- The Delhi High Court in the case of New Skies Satellite BV[2] has elaborated on the general principles relating to international transactions of the tax treaty vis-à-vis royalty and also the amendment in the Act widening the scope of royalty. The High Court held that amendments in the domestic law cannot be read into tax treaty provisions without amending the tax treaty itself. It was held that mere amendment to Section 9(1)(vi) of the Act could not result in a change and it was imperative that such amendment was brought about in the tax treaty as well and hence, the amendments were not applicable to the tax treaty.
- In view of the ratio laid down by the Delhi High Court in the case of New Skies Satellite BV and Delhi Tribunal in Shin Satellite Public Co. Ltd.[3], the Tribunal in the instant case are not going into the aspect of the amendment to Section 9(1)(vi) of the Act, under which Explanations 4, 5 and 6 of the Act have been added, which interalia, amended the definition of 'royalty' with retrospective effect. It has been held that the same need not to be gone into since the issue otherwise stands decided in favour of the taxpayer.
- Unilateral amendment by the Indian government to the term 'royalty' by way of amendment to Section 9(1)(vi) of the Act cannot be extended to the meaning of the term under a tax treaty. Applying the principle laid down by the Delhi High Court in the case of New Skies Satellite BV, the Tribunal held that where the provisions of tax treaty override the provisions of the Act and the definition of 'royalty' not having undergone any amendment in the tax treaty, the taxpayer was not liable to deduct tax on the lease line charges paid by it. The amended provisions of Section 9(1)(vi) of the Act brought into force by the Finance Act, 2012 are applicable to domestic laws and the said amended definition cannot be extended to the tax treaty, where the term has been defined originally and not amended.
- In the present case also, though the definition of 'royalty' under the Act had been amended, the term 'royalty' under the India-U.S. tax treaty has not been amended. In the absence of the same, the Tribunal held that in view of the definition of 'royalty' under the tax treaty, the taxpayer is not liable to deduct tax on the payments made to its AE on account of lease line charges.

[2] DIT v. New Skies Satellite BV [2016] 382 ITR 114 (Del)
[3] Shin Satellite Public Co. Ltd. v. DDIT [2011] 12 taxmann.com 6 (Del)

Our comments

The issue with respect to taxability of reimbursement of expenditure has been a matter of debate before the courts/Tribunal.

In some of the cases[4], the Tribunal held that reimbursement of expenditure is not taxable since there is no profit element. On the other hand, in some of the cases[5] courts/Tribunal have treated the reimbursement of expenditure as income of recipient liable to tax in India.

Further, reimbursements under the cost allocation agreement have been held to be taxable in some of the cases[6]. However, in some of the cases[7], courts have treated that such payment as service fees instead of reimbursement of expenditure.

The Pune Tribunal in the present case held that reimbursement of expenditure do not include any income element and therefore the same is not subject to tax in India. Accordingly, where the taxpayer had reimbursed the expenditure having no income element, there is no requirement to deduct tax on such payments.

It is pertinent to note that the Supreme Court[8] has observed that no profit element was embedded in the payment made by Indian agents to the foreign company. The payments were in the nature of reimbursement of cost whereby the agents paid their proportionate share of expenditure incurred on the said systems and for maintaining those systems. Accordingly, such payment was not taxable as FTS.

The courts/Tribunal in various decisions[9] has held that amendment in the Act would not affect the provisions of the tax treaties unless the same are ratified by both the signatories of the tax treaty.

Similarly, the Tribunal in the present case also held that though the definition of 'royalty' under the Act had been amended, but the term 'royalty' under the tax treaty is not amended. The provisions of tax treaty override the provisions of the Act and the definition of 'royalty' not having undergone any amendment in the tax treaty, the taxpayer was not liable to deduct tax on the payment of lease line charges.

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[4] Convergys Customer Management Group Inc. v. ADIT [2014] 159 TTJ 42 (Del), Dampskibsselskabet v. ADIT [2011] 130 ITD 59 (Mum), CIT v. Expeditors International (India) (P.) Ltd. [2012] 209 Taxman 18 (Del), Bureau Veritas-Indian Division v. ADIT [2015] 54 com 139 (Mum), Gemological Institute International Inc v. DCIT [2017] 166 ITD 8 (Mum)

[5] SPX India (P.) Ltd. v. CIT [2014] 147 ITD 120 (Del), CSC Technology Singapore Pte. Ltd. v. ADIT [2012] 50 SOT 399 (Del), Ashok Leyland Ltd. v. DCIT [2008] 119 TTJ 716 (Chen), Inspections (I) (P.) Ltd. v. DCIT [2013] 156 TTJ 690 (Mum)

[6] Danfoss Industries (P.) Ltd., In re [2004] 268 ITR 1 (AAR), A' Systems, The Netherlands, In re [2012] 345 ITR 479 (AAR).

[7] Van Oord ACZ Marine Contractors BV v. ADIT [2012] 149 TTJ 124 (Chen), Danfoss Industries (P.) Ltd., In re [2004] 268 ITR 1 (AAR)

[8] [2016] 392 ITR 186 (SC)

[9] DCIT v. Bank of India (ITA No. 3082/Mum/2015), Sanofi Pasteur SA v. Dept of Revenue [2013] 354 ITR 316 (AP)

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