



# Tax Flash News



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## Arbitral award arising under a business contract classified as business income and not other income

### Executive summary



The characterisation of a one-off receipt within the scope of business activities has often been a contentious issue as the tax implications can differ based on the nature of the receipt – business income or other income. In such instances, the key determinant is whether the payment is incidental to the business or arises in the normal course of business.

In the case of *Fujitsu Ltd*<sup>1</sup>, the Delhi Bench of the Tribunal dealt with the characterisation of compensation received under an arbitral award and incidental interest income thereon.

The Tribunal accepted the taxpayer's position that the compensation arose from the taxpayer's core business activities and thus, business income in nature. As the interest was only an accretion to the principal compensation, the interest also qualifies as business income.

Such payments are not taxable in India in the absence of the non-resident taxpayer having a permanent establishment in India as per the applicable tax treaty.

The Tribunal rejected the Revenue's position that such receipts are passive income and are taxable as 'Other Income'.

<sup>1</sup> *Fujitsu Ltd v. ACIT* (ITA No. 2607/Del/2022). Source: Taxsutra

## Facts of the case



The taxpayer, a tax resident of Japan, was engaged in the business of providing IT services, maintenance support, and software licensing.

The joint venture of the taxpayer with its Indian group company had an agreement with an Indian customer to supply the telecom equipment.

During the year under consideration, the taxpayer received the compensation awarded under an arbitral decision.

The arbitral compensation resulted from the customer's non-payment of dues for the delivered goods.

Apart from the principal compensation, the taxpayer also received an interest earned on this compensation deposited with an Indian bank during the pendency of litigation with the customer.

In its tax return, the taxpayer classified the principal compensation as business income and asserted that it was not taxable in India due to the absence of a permanent establishment (PE) in India as per the India-Japan tax treaty (the treaty).

The interest was offered to tax at the concessional rate of 10 per cent under the treaty.

The tax officer disputed this classification, treating both the components as 'income from other sources' under the Act and 'Other Income' under the treaty. The treaty article dealing with 'Other Income' grants the taxation rights to the source state (India in the instant case).

## Taxpayer's contentions



The principal compensation arose from business transactions and in the ordinary course of its business. Accordingly, the principal compensation is business income in nature.

The interest income is incidental to its business and should also be treated as business income under the treaty. Though it was voluntarily offered to tax in its tax return, the interest income was also not taxable in India.

Reliance was placed on the decisions in the case of *Goldcrest Exports*<sup>2</sup> and *3F Industries*<sup>3</sup> to establish that arbitral compensation and related interest constitute business income and are non-taxable in the absence of a PE in India.

<sup>2</sup> *Goldcrest Exports v. ITO* [2010] 134 TTJ 355 (Mum)

<sup>3</sup> *3F Industries Ltd v. ACIT* [2019] 108 taxmann.com 79 (Visakhapatnam - Trib.)

## Revenue's contentions



The compensation was a one-time, non-recurring gain not arising directly from regular business operations. It is a windfall gain awarded by a court of law.

The taxpayer had not incurred business expenses in India related to the disputed income, which suggested passive nature of income rather than active business income. The Business Income article under the treaty was inapplicable due to the taxpayer's lack of substantial business operations in India.

No privity of contract: The taxpayer was not a direct contracting party with the Indian customer. The contract with the customer was awarded to the consortium with the taxpayer's Indian group company as the lead partner. The taxpayer played an incidental and subsidiary role, not directly involved in the business and contract with the customer.

To rebut this, the taxpayer submitted the copies of arbitration orders, High Court order and contracts to substantiate its claim. It emphasised that the arbitral tribunal explicitly recognised it as a contracting party with the customer.

## Decision



The Tribunal ruled in favour of the taxpayer.

The principal compensation arose from the taxpayer's core business activities and thus, retained its character as business income under the treaty.

The interest on delayed payments is incidental to business income and shares the same tax treatment as the principal compensation.

In this regard, reference was made to the Supreme Court's judgment in the case of *Govinda Choudhary*<sup>4</sup> wherein it was held that such an interest is only an accretion to the taxpayer's receipt from the contract. It shares the same nature as the receipts for the payment it was entitled to under the contract, which were delayed due to certain disputes between the parties.

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<sup>4</sup> *CIT v. Govinda Choudhary & Sons* [1993] 203 ITR 881 (SC)

## Our comments



By recognizing the contractual origins of the compensation and its linkage to business activities, this decision underscores the need for precise classification of income to avoid unjust taxation and provides clarity on handling similar disputes involving arbitral awards.

The ruling is a reminder to businesses to maintain robust documentation to support their tax positions.



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