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Tax Flash News

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Unilateral amendment in domestic tax law cannot expand the scope of royalty taxation under the tax treaty

Executive summary

In the past, there have been amendments in the Income-tax Act, 1961 (the Act) to expand the scope of source-based taxation for the non-residents. An issue arises whether such expanded scope under the Act can affect the taxation under the applicable tax treaty.

In the context of taxability of the bandwidth and transmission services, the Act was amended to define the term 'process' in a wide manner and expand the scope of equipment royalty and the Revenue has been applying these amendments to interpret the royalty provisions of the treaties.

The Delhi High Court in the case of *Telstra Singapore Pte Limited*[1] held that the meaning of the term under the Act can be taken in a restricted sense only. As the term 'royalty' is defined under the India-Singapore tax treaty (the treaty), a unilateral amendment in the Act which travel beyond explaining a doubtful term in a treaty and which enlarge or broaden the scope of taxation, cannot be imported in a tax treaty.

Accordingly, the consideration for bandwidth services is not taxable as process royalty or equipment royalty as there was no use or right to use any process or equipment.

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[1] *CIT* v. *Telstra Singapore Pte Limited* (ITA 334/2022) (Del) – Source: Taxsutra

Relevant provisions of treaty and Act

- The term ‘royalty’ under the treaty, *inter alia*, means consideration for the use of, or the right to use, (i) any secret formula or process (process royalty) or (ii) any industrial, commercial or scientific equipment (equipment royalty).
- The term ‘process’ is not defined under the treaty. If the term is not defined in the treaty, it shall have the same meaning as it has under the domestic laws of the country applying the treaty unless the context requires otherwise.[2]
- The Finance Act, 2012 amended the provisions under the Act[3] and defined the term 'process’ to include transmission by satellite, cable, optic fiber or by any other similar technology, whether or not such process is secret. Similarly, it was clarified that royalty includes consideration in respect of right or property whether or not the payer has its possession or control.
- The issue arose whether these amendments under the Act can be applied to interpret the royalty provisions under the treaty.

Facts of the case

- The taxpayer, a resident of Singapore, was engaged in the business of providing the connectivity solution i.e., bandwidth services.
- To provide such services, the infrastructure and equipment owned by the taxpayer was situated outside India. For providing communication services within India, the taxpayer entered into an agreement with an Indian telecom operator.
- The issue arose whether the consideration received from Indian customers for the bandwidth services was taxable as a process royalty or equipment royalty under the treaty.

Revenue’s contentions

- The amendments in the Act were clarificatory in nature and have retrospective effect. It includes the bandwidth services within the ambit of royalty taxation.
- The royalty provisions of the treaty do not define the term ‘process’ and thus its meaning has to be taken from the Act.[4]

[2] Article 3(2)

[3] With retrospective effect from 1 June 1976

[4] Article 3(2) of the treaty and *CIT* v. *P.V.A.L Kulandagan Chethiar* [2004] 267 ITR 654 (SC)

- The courts have to follow the ambulatory approach (i.e., refer to the domestic law provisions as it stands at the time of applying the treaty provisions), as opposed to a static approach (referring the domestic law provisions as they stand at the time when the treaty was entered into)[5]. As the definition of the term 'process' exists under the Act for the year under consideration, the same meaning is to be taken to apply the treaty provisions.
- The services provided by the taxpayer involved 'use' and 'right to use' industrial, commercial or scientific equipment and thus was taxable as equipment royalty.
- The Revenue relied on the Madras High Court's decision in the case of *Verizon Communications*[6] where the High Court relied on the amendments to royalty provisions and held that the payment for bandwidth services was for the use or right to use of the equipment, as well as for the use of the process and thus taxable as royalty.

[5] The relevant treaty entered into force in 1994, while the years under consideration was FY 2010-11 to 2018-19 and the amendment in the Act was introduced by the Finance Act, 2012 with retrospective effect from 1 June 1976

[6] *Verizon Communications Singapore Lte. Ltd*. v. *ITO* [2013] 361 ITR 575 (Mad)

Taxpayer's contentions

- The consideration received for the bandwidth services was not taxable as process royalty or equipment royalty.
- An amendment is clarificatory only if it explains an ambiguous provision or where the provision suffers from an obvious omission or has more than one meaning. The amendment to the royalty definition under the Act was transformative and substantive in nature. Such an amendment under the Act cannot be read into the treaty.
- The Revenue's contentions for invoking definition under the Act were clearly unsustainable since the identical arguments were negated by the Delhi High Court in the case of *New Skies Satellite*[7].
- In the royalty definition under the India-Hungary tax treaty, the transmission by satellite, cable, optic fibre or any other similar technology is mentioned separately from the category pertaining to process or equipment. Thus, the consideration for transmission is distinct from, and not covered by, the process royalty and equipment royalty.

[7] *DIT* v. *New Skies Satellite BV* [2016] 382 ITR 114 (Del)

- The taxpayer was providing standardised services. The services were on a non-exclusive basis, and the customers did not have control or dominion over the infrastructure or the equipment of the taxpayer.[8]
- In the definition of royalty, the term ‘process’ appears along with various species of intellectual property rights and thus, it should derive its meaning therefrom. By providing the bandwidth services, no intellectual property right was granted to the customers.

High Court’s decision

The consideration received for the bandwidth services was not taxable as process royalty or equipment royalty based on the following grounds:

- The changes in domestic legislation cannot override the treaty provisions and unilateral amendments in the royalty provisions under the Act cannot overcome the treaty provisions.[9]
- Article 3(2) of the treaty would be applicable only to for term appearing in the tax treaty and which has not been defined therein. However, the term ‘royalty’ is defined under the treaty.
- The article does not envisage an entire adoption or importation of domestic legislation. The resort to domestic legislation is restricted.
- The theory of ambulatory approach may apply to treaty interpretation. However, the same cannot empower a treaty country to undertake an amendment to basic and fundamental concepts of the treaty. The unilateral amendments which travel beyond explaining an obscure or doubtful expression appearing in a treaty and which enlarge or broaden the scope of taxation itself would clearly not fall within the permissible scope of the ambulatory approach.
- Even though royalty provisions under the Act were amended in 2012, no corresponding amendments were introduced under the treaty.

[8] *Asia Satellite Telecommunications Co. Ltd. v. DIT (2011) 332 ITR 340 (Del)*
[9] *DIT* v. *New Skies Satellite BV* [2016] 382 ITR 114 (Del), Engineering Analysis Centre of Excellence (P.) Ltd *v. CIT [2021] 432 ITR 471 (SC)*

- The Madras High Court decision in the case of Verizon Communications was on the premise that the definition of royalty under the tax treaty as well as the Act are pari materia. However, this premise was incorrect. The decision of the Madras High Court was merely on the basis of royalty provisions of the Act which was not a correct approach.
- In the instant case, there was no transfer of a right to use of a process or technology or control and dominion over equipment to the customers. The mere enjoyment of a service or facility does not constitute a right to use[10]. The mere utilisation of a process or equipment in the course of providing a services would not qualify the test of use or right to use as contemplated under the royalty definition of the treaty.
- The High Court relied on the decisions of *Asia Satellite, New Skies Satellite and Engineering Analysis*.

Our comments

The Delhi High Court has reiterated that the reference to the domestic law for interpreting the treaty provisions is permissible only in restrictive manner. Such a reference should not expand the scope of taxation of income which is not envisaged by the treaty provisions.

Though the High Court accepted the application of ambulatory approach in principle, it further added that the same should not apply to import a substantial amendment in the Act to fundamentally alter the essential bargain struck by the treaty countries.

[10] *Asia Satellite Telecommunications Co. Ltd.* v. *DIT* (2011) 332 ITR 340 (Del)

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