Tax Matters

Issue No. 2021/04 Date: 21 April 2021

The team at JMP Advisors is pleased to bring to you a gist of some of the significant developments in the direct tax space during March 2021:

Income tax rulings

➢ Payments made for computer software not taxable as royalty

- Engineering Analysis Centre of Excellence Private Limited v. CIT & ANR. (SC) (Civil Appeal Nos. 8733 & 8734 of 2018)

The Honourable ('Hon'ble) Supreme Court ('SC') ruled in favour of the taxpayer and held that payments made by resident Indian end-users or distributors to non-resident computer software manufacturers or suppliers towards resale or use of the computer software cannot be considered as royalty payments for the use of copyright in the computer software, under relevant Double Taxation Avoidance Agreement ('DTAA'). Accordingly, the payment is not liable to withholding tax.

While rendering the aforesaid judgement, the Hon'ble SC has analysed that the definition of 'royalty' contained in Article 12 of the various DTAA's and observed that the distribution agreements / End User Licence Agreements ('EULAs') under which such payment is made do not create any interest or right in such distributors / end-users, which would amount to the use of or right to use any copyright. Section 9(1)(vi) of the Income-tax Act, 1961 ('the Act') cannot bring such payments to tax as royalty since they are not beneficial to the taxpayer as compared to the relevant provisions of the various DTAA's.

The Hon'ble SC examined the distribution agreements / EULAs and observed the following:

i. No copyright in the computer programme is transferred either to the distributor or to the ultimate end-user.

ii. There was no further right to sub-licence or transfer.

iii. There was no right to reverse-engineer, modify, reproduce in any manner otherwise than permitted by the licence to the end-user.

The Hon'ble SC stated that the above restrictions indicate that only a non-exclusive, non-transferrable licence to resell computer software is transferred. Accordingly, the consideration paid by distributor is the price towards purchase of computer programmes as goods, either in a medium which stores the software or in a medium by which software is embedded in hardware for onward resale, and the distributor gets no right to use the product.

When it comes to the end-users, under the EULAs, they can only use it by installing it in the computer hardware owned by them. The end-user cannot reproduce the same for sale or transfer. Thus, licence transferred is not a licence in terms of section 30 of the Indian Copyright Act but a licence imposing restrictions or conditions for the use of computer software.

Thus, based on the aforesaid facts and drawing reference from various landmark rulings on this issue, the Hon'ble SC concurred with the view that the right to reproduce and the right to use computer software are distinct and separate rights and in the absence of fulfilment of conditions for determining the payment in the nature of royalty, the taxpayer is justified in not withholding tax while making payment to the non-resident software manufacturers / suppliers.

Some of the other important key takeaways from this judgement:

- A 'person' resident in India is liable to withhold tax under section 195 of the Act only if the non-resident payee is liable to pay tax under the Act. Where a DTAA applies, the provisions of the Act shall apply only if they are more beneficial to the tax payer;

- The law does not demand the impossible and when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused; and

- OECD commentary continues to have persuasive value.

JMP Insights – *The issue of taxability of payment for software as royalty has been a contentious issue in India for many years. The distinction between 'copyright' and 'copyrighted article' has been made in may rulings and it has been held that if the payment is towards transfer of a 'copyrighted article' and not the 'copyright' itself, then the payment is not in the nature of royalty.*

The Finance Act, 2012 had expanded the definition of royalty to include right for use or right to use a computer software, including granting of a license. However, there is no corresponding amendment in the various DTAAs entered by India. Hence, in such cases, the DTAAs being more beneficial are applicable to the taxpayer.

It is pertinent to note that the Finance Act, 2021 provides that Equalisation Levy shall not apply if consideration for specified services and for e-commerce supply or services is taxable as royalty / fees for technical services under the Act read with the DTAA. Therefore, now with further clarity on this issue, if the payment to non-residents is not taxable as royalty, taxpayers will need to evaluate with greater care the applicability of Equalisation Levy in all such cases.

- **Payment made to law firm in Australia and Chartered Accountant company in USA considered as business income and hence not taxable in India in absence of a Permanent Establishment**

  - Sundaram Business Services Limited v. ITO (Chennai ITAT) (ITA No. 771/CHNY/2019)

The taxpayer is engaged in the business of providing IT enabled services and outsourcing services. It has paid professional charges to KL Gates, a law firm in Australia and TWB Pty Ltd., a Chartered Accountant ('CA') company in USA without withholding tax on the payment made towards professional services rendered by the law firm and the CA company outside India. The tax officer disallowed the expenditure claimed in the return of income under section 40(a)(i) of the Act on account of non-withholding of tax at source.

The main issue before the Chennai Income Tax Appellate Tribunal ('ITAT') was the requirement of withholding tax on such payments under the domestic law vis-à-vis the respective DTAA.

As regards the payment to the law firm in Australia, ITAT noted that as per Article 14 of the India-Australia DTAA, any professional services rendered by an individual or a firm of individuals (other than a company) who is resident of one of the contracting states is taxable only in that state unless the individual or the firm has a fixed base in the other state. Based on the details submitted by the taxpayer, it was held that the professional services rendered by the law firm are covered under Article 14 - Independent Personal Services of the India-Australia DTAA and in the absence of a fixed base of the payee in India, the taxpayer is not liable to withhold tax under section 195 of the Act.

As regards the payment of professional charges to the CA company in USA since the legal status of the CA is a company, it would not be covered under Article 15 (Independent Personal Services) of the India-USA DTAA.

It would also not be covered under Article 12 of the India USA-DTAA as fees for technical services as the Article contains the 'make available' clause. Broadly, the term 'make available' means that the person acquiring the service is enabled to independently apply the technology. In view of this, the ITAT held that the payment will fall under Article 7 of the India-USA DTAA and in the absence of a Permanent Establishment of the CA company in India, the business income shall not be taxable in India and as such, the taxpayer is justified in not withholding tax under section 195 of the Act.

JMP Insights: *The exercise of analysing the applicability of each relevant Article of the DTAA along with the provisions of the domestic law requires in-depth research and technical interpretation. Payments towards professional services requires a detailed understanding of facts to determine its taxability.*

- **Twin conditions need to be satisfied to characterize payment as reimbursement of expenses**

  - BYK Asia Pacific Pte. Limited v. ACIT (IT) (Pune ITAT) (ITA No. 2110/PUN/2019)

The issue under consideration was whether payments made by Indian branch office of the Singapore company towards seminar expenses, training expenses, printing expenses and staff welfare expenses without withholding of tax under section 195 of the Act should be disallowed under section 40(a)(i) of the Act.

The Pune ITAT observed that withholding of tax is required to be made under section 195 of the Act only when the payment is chargeable to tax in India in the hands of the non-resident. Chargeability pre-supposes some profit element involved in the receipt. If the recipient simply recovers the amount spent by it without any profit element, such a receipt, being reimbursement, cannot be considered as a sum chargeable to tax in India.

Twin conditions need to be satisfied to classify payment as reimbursement:

a. One-to-one direct correlation between the outgo of the payment and inflow of the receipt must be established.

b. The receipt and the payment must be of identical amount.

The first condition gets satisfied when there is a directly identifiable amount which is spent on behalf of another and later it is recovered as such from the latter. The second condition gets satisfied when the amount received back is the amount originally spent without any mark-up.

The ITAT held that on going through the documents/materials, it is evident that the aforementioned twin conditions are satisfied and hence there is no requirement to withhold tax under section 195 of the Act. Accordingly, there is no question of disallowance under section 40(a)(i) of the Act.

As regards the IT expenses, ITAT noted that with respect to payment of allocated IT expenses, the taxpayer needs to demonstrate that allocation of IT expenses is without any mark up. The burden to prove a particular expenditure as reimbursement is always on the taxpayer. Receipt of a fixed amount, which may be more or less than the actual outgo, cannot be designated as `reimbursement' as held by the Hon'ble SC in the case of Sedco Forex International Inc. v. CIT [(2017) 399 ITR 1].

The ITAT noted that the taxpayer is unable to provide the IT Support Services Agreement and lower authorities have not examined the nature of IT expense by perusing the IT Support Services Agreement. It has not been examined whether the IT services are to be utilized in its activity of rendering technical services to its customers or the IT services are utilized towards business process outsourcing. Accordingly, it directed the tax officer to examine the true nature of transaction and then determine whether there was any requirement to withhold tax under section 195 of the Act.

JMP Insights – *On the aspect of pure reimbursement of expenses, the Pune ITAT decision is a welcome decision as it lays down the principle that twin conditions have to be satisfied before any payment is characterized as reimbursement of expenses.*

As regards the IT support services, it is a common feature in large multinational organisations to allocate the IT expenses to all the group companies and recovery of the allocated expenses under a cost sharing arrangement. However, in such cases it is pertinent to evaluate various underlying factors such as basis of allocation, the value addition by the entity pooling the cost and the benefits derived by the participating entities.

Further, it is important to maintain strong documentary evidence to demonstrate the actual nature of transaction.

- **Investment in India made by a non-resident through his bank account abroad cannot be taxed in India as unexplained credits**

  - Mr. Iqbal Ismail Virani v. ITO (IT) (Panaji ITAT) (ITA No. 187/PAN/2019)

The Panaji ITAT while ruling in favour of the taxpayer has held that remittance received by a non-resident taxpayer from his foreign bank account to his Indian bank account by way of sale of investments made outside India, is neither income received or deemed to be received in India nor accrued or arisen or deemed to be accrued or arisen in India. Therefore, the question of chargeability to income tax in India does not arise.

The taxpayer had bought two flats in Mumbai from the money earned outside India which was brought in India through banking channels from Dubai. The tax officer added such amount as income of the taxpayer on account of unexplained credit under section 68 and 69 of the Act disregarding the taxpayers' contention that investment was made from the sale proceeds of gold bars in Dubai and out of maturity proceeds of Fixed Deposits ('FD') of the company owned by the taxpayer. The taxpayer explained that he earned the money through various businesses of gold, hotel etc. in USA and Dubai and provided the purchase orders and the money receipt. He explained that the money was transferred to the Indian account through normal banking channels and the same has been invested in the flats.

The ITAT relied on the decision of the Hon'ble SC in the case of Keshav Mills Ltd (23 ITR 230) and the Central Board of Direct Taxes ('CBDT') Circular No. 5 dated 20 February 1969 and stated that the money brought in India by non-resident for investment or any other purpose is not liable to tax in India. It explained that the question of assessing such remittance to tax arises only when there is no evidence to show that the amounts are in fact remittances from abroad. In this case, there is ample evidence in the form of confirmation letter from Bank of Baroda in Dubai with respect to maturity proceeds of fixed deposits ('FDs'), invoices supporting sale of gold bars in Dubai and copies of cheque issued in favour of taxpayer that the amounts are remittances from abroad.

JMP Insights: *It has been reiterated in this decision that once the income is received abroad, its subsequent remittance to India cannot be considered as income received in India and cannot be taxed in India on that basis. The tax officer does not have the jurisdiction to question the source of income of a non-resident which is not taxable in India just because it is subsequently remitted to India.*

- **A bank passbook or bank statement cannot be considered to be a book for the purpose of section 68 of the Act and amount credited therein cannot be treated as unexplained cash deposit**

  - Vishan Swaroop Gupta v. ITO (Jaipur ITAT) (ITA No.13/JP/2020)

The issue under consideration before the Jaipur ITAT was whether a bank passbook or a bank statement can be considered to be a 'book' for the purpose of section 68 of the Act and any unexplained cash deposits appearing in the bank passbook or bank statement of the taxpayer be sufficient evidence to treat them as unexplained cash credits under section 68 of the Act.

The taxpayer is a retired doctor who had deposited cash in his bank account. The tax officer added the amount to the returned income by invoking section 68 of the Act as unexplained cash deposit. The taxpayer argued that the cash deposited in the bank account was his savings and the household expenses were met out of savings of his wife. The taxpayer also argued that in order to invoke section 68 of the Act, there are three conditions which need to be satisfied:

- any sum is found credited in the books of a taxpayer;
- the taxpayer offers no explanation about the nature and source thereof;
- the explanation offered by him is not, in the opinion of the tax officer, satisfactory.

In this case, the taxpayer is not liable to maintain any books of account under section 44AA of the Act. Moreover, relying on the judgement of the Bombay High Court ('HC') in case of Bhaichand N. Gandhi (141 ITR 67) and the Mumbai ITAT in the case of Manshi Mahendra Pitkar [(2016) 73 taxmann.com 68 (Mumbai Trib.)], the Jaipur ITAT held that *"a bank pass book or bank statement cannot be considered to be a 'book' maintained by the assessee for any previous year for the purpose of Section 68 of the Act".*

The ITAT directed the assessing officer to delete the addition on the basis that a bank pass book or a bank statement cannot be considered to be a 'book' maintained by the taxpayer for the purpose of section 68 of the Act. Accordingly, credit in bank account cannot be construed to be equivalent to credit in books of accounts of the taxpayer.

JMP Insights: *The Agra ITAT in the case of Smt. Renu Agrawal [2012] 22 taxmann.com 94 (Agra) (TM) distinguished the Bombay HC judgement in the case of Bhaichand N. Gandhi and held that bank pass book is the property of the taxpayer maintained by the*

bank, and therefore, rigors of section 68 of the Act are applicable to unexplained entries in the pass book, and will amount to credit in the books of account.

For the purpose of applying section 68 of the Act, the tax authorities need to establish that there is unexplained credit in the books maintained by the taxpayer. The moot question whether books includes bank pass book remains litigious in light of the differing views of the Jaipur ITAT and Agra ITAT.

DID YOU KNOW?

A Tax Audit Report ('TAR') issued by a Chartered Accountant can now be revised

If after furnishing of the original TAR, a payment is made which necessitates recalculation of disallowance under section 40 or section 43B of the Act, the taxpayer can get the TAR revised within the specified period.

Should you wish to discuss any of the above issues in detail or understand the applicability to your specific situation, please feel free to reach out to us on coe@jmpadvisors.in.

JMP Advisors Private Limited

12, Jolly Maker Chambers II, Nariman Point, Mumbai 400 021, India
T: +91 22 22041666, E: info@jmpadvisors.in, W: www.jmpadvisors.com

About JMP Advisors

JMP Advisors is a leading professional services firm that offers advisory, tax and regulatory services. The vision of JMP Advisors is to be 'The Most Admired Professional Services Firm in India'. It aims to be the best as measured by the quality of its people and service to clients. The firm has a merit-based culture and operates to the highest standards of professionalism, ethics, and integrity. Jairaj (Jai) Purandare, the Founder Chairman has over three and half decades of experience in tax and business advisory matters and is an authority on tax and regulation in India. Jai was Regional Managing Partner, Chairman-Tax and Country Leader-Markets & Industries of PricewaterhouseCoopers India. Earlier, Jai was Chairman of Ernst & Young India and Country Head of the Tax & Business Advisory practice of Andersen India.

JMP Advisors offers advice in international taxation, domestic taxation, transfer pricing, mergers and acquisitions, Goods and Services Tax (GST), business laws and exchange control regulations and foreign investment consulting. We specialize in fiscal strategy and policy foresight and are trusted advisors to high net worth families. Our team at JMP Advisors takes pride in being the best at what matters most to clients-technical expertise, innovative solutions, consistent, high quality service, reliability, and ease of doing business.

JMP Advisors has been recognized as a leading Tax firm in India in the International Tax Review (Euromoney) World Tax Directory for all successive years since incorporation, including in the World Tax and Transfer Pricing 2021 Directory.