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Payment to HO for data processing charges not '*royalty*' under the India-Belgium tax treaty; such expense cannot be clubbed under HO expenses under section 44C

In brief

The Mumbai Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of Antwerp Diamond Bank NV[1] held that charges paid to the taxpayer (head office, HO) by its Indian branch for data processing work done on software owned by the taxpayer was not '*royalty*' under Article 12(3) of the India-Belgium Double Taxation Avoidance Agreement (the tax treaty). As such the payment was not *qua* **use or for right to use** software exclusively by the Indian branch. The payment was also fully deductible as it fell outside the purview of HO expenses under section 44C of Income-tax Act, 1961 (the Act) as they were directly related to the taxpayer's banking business. It further held that the definition of '*royalty*' as amended retrospectively by Explanations 4 and 5 to section 9(1)(vi) of the Act could not be read into, or influence the definition of, Article 12(3) of the tax treaty.

Facts

The taxpayer, a bank incorporated in Belgium, operated through a branch in India. The taxpayer claimed HO expenses as reimbursements, attributable to its banking business operation in India. The expenses were classified as general administrative expenses and data processing cost. The Indian branch reimbursed to the HO on account of data processing charges attributable to the Indian banking business for *pro rata* use of the banking software owned by the HO, under an agreement that

[1] ADIT *v.* Antwerp Diamond Bank NV [TS-150-ITAT-2014(Mum)]

gave it a license for royalty-free, non-transferable right to use software purchased by the HO. However, the tax officer (TO) disallowed the entire HO expenses under section 40(a)(i) of the Act relying upon various decisions[2]. According to the TO, the payment made by the taxpayer was towards reimbursement of cost to HO and was in the nature of '*royalty*'. Hence, the taxpayer was required to withhold tax under section 195 of the Act. On appeal, the Commissioner of Income-tax Appeal (CIT(A)) directed the TO to modify the assessment and delete the double disallowance. The general administrative expenses were to be allowed under section 44C of the Act dealing with HO expenses deductibility. Further, the data processing cost relating directly to banking business was not covered within the ambit of general administrative expenses and hence, had to be treated as business expenses.

Issues before the Tribunal

- Whether payment made by the Indian branch to its HO towards cost of data processing on computer software belonging to HO, was not taxable in India as 'royalty' as per Article 12(3) of the tax treaty?

- Whether data processing expenses could be clubbed with general administrative expenses under section 44C of the Act?

Revenue's contentions

- Although the server was in Belgium and there was no direct possession of any technology or equipment or transfer of any right, by virtue of Explanations 4 to 6 to section 9(1)(vi) of the Act introduced by the Finance Act, 2012, with retrospective effect from 1 June 1976, such a payment would be covered under the ambit of 'royalty' or 'fee for technical services'.

- Explanation 5 to section 9(1)(vi) would apply under Article 12 of the tax treaty also, because if the possession of software was with the owner and it had parted with the right to use, then the consideration for the same would constitute '*royalty*'. The revenue also referred to two other decisions[3] where it had been held that grant of right to use of online database and other software services was nothing but '*royalty*'.

- The taxpayer's claim that the payment was in the nature of reimbursement could not have been accepted without any record showing that the amount payable did not have any income element or represented purely reimbursement of cost. The onus to prove that there was no element of profit on such reimbursement was always upon the taxpayer.

Taxpayer's contentions

- According to the taxpayer, there was no scientific knowledge or knowhow provided by the HO to the Indian branch. It referred to the case of Kotak Mahindra Primus Ltd[4] where a similar kind of payment for data processing on the computer system belonging to the foreign company was held not to be 'royalty' or 'fee for technical services', within the meaning of Article 12 of the India-Australia tax treaty.

- Referring to Article 12 of the tax treaty, the taxpayer submitted that the usage for data processing by the branch of the software acquired by the HO and permitted to be used by the branch office could not be held to be for the 'use' or 'right to use'. It could not be akin to any of the terms mentioned in the said Article. Even under the Explanation to section 9(1)(vi) of the Act, the cost of data processing could not be equated with payment of '*royalty*'.

- As per the OECD commentary, the Article dealing with '*royalty*' did not apply to the payments for the new information obtained as a result of performance of services at the request of the payer. Once the payment was considered not to be on account of royalty, then the question of disallowance under section 40(a)(i) of the Act did not arise.

[2] Micoperi SPA Milano *v.* DCIT [2002] 82 ITD 369 (Mum) and DCIT *v.* Campaign Franchise ITA No.3445/Mum./1998, order dated 20 August, 2003

[3] Verizon Communication Singapore Pte Ltd. *v.* ITO [2013] 39 taxmann.com 70 (Mad.) and CIT *v.* Wipro Ltd. [2012] 203 Taxman 621 (Kar)

[4] Kotak Mahindra Primus Ltd. *v.* DDIT [2007] 11 SOT 578 (Mum)

Tribunal's decision

- Definition of '*royalty*' as per Article 12(3)(a) of the tax treaty provided that only when the payment of any kind was received as consideration for 'use' of or 'the right to use' any copyright of any item or for various terms used in the said Article, could it be held to be '*royalty*'.

- The aforementioned definition of '*royalty*' was exhaustive and not inclusive, and hence, it had to be given the meaning as contained in the Article itself and no other meaning should be looked into. If the taxpayer claimed the application of the tax treaty, then the definition and scope of 'royalty' given in the domestic law[5], *viz.*, section 9(1)(vi) of the Act, should not be looked into.

- The character of payment towards '*royalty*' depended upon the independent 'use' or the 'right to use' of the computer software, which was a kind of copyright. In the present case, the payment made by the branch was not for 'use' or 'right to use' software, which was being exclusively done by the HO, installed in Belgium. The branch did not have any independent right to use or control over the computer software, but it simply sent the data to the HO for getting it processed.

- The branch was only reimbursing the cost of processing of such data to the HO, which had been allocated on *prorata* basis. Such reimbursement of payment was not covered within the ambit of definition of 'royalty' within Article 12(3)(a) of the tax treaty. To be covered within its ambit, the branch should have had exclusive and independent **use or right to use** the software and payment had to be made as consideration for such usage.

- There was no such **right** that had been acquired by the branch in relation to the usage of software, because the HO alone had the exclusive right of the license to use the software. Thus, the reimbursement of data processing cost to the HO was not covered within the ambit of the definition of '*royalty*' under Article 12(3)(a) of the tax treaty.

- Therefore, the Tribunal held that the payments made by the branch to the HO towards reimbursement of cost of data processing could not be held to be covered within the scope of the expression, '*royalty*' under Article 12(3)(a) of the tax treaty. Also, as the data processing cost paid by the taxpayer was not royalty, there was no requirement for withholding tax on such payment. Therefore, section 40(a)(i) of the Act would not apply.

- Further, the data processing cost pertained to allocation of expenses incurred by the HO on *pro rata* basis for the banking application software acquired by the HO. Such expenditure was not covered within the meaning of 'HO expenses' as provided in section 44C of the Act. The nature of expenses as given in section 44C of the Act had to be necessarily in the nature of executive and general administrative expenses only.

PwC observations

- The decision improves clarity on the tests for characterisation of data processing as '*Royalty*' or otherwise in the context of tax treaties. The Tribunal has, in this context, brought back the focus of the tests to whether or not payment made is for "use" of or "right to use" of software. The decision has also sought to restore respect to the fundamental rule of international taxation that the domestic law cannot be applied where the taxpayer has relied on the tax treaty. Hopefully, this will temper revenue's propensity to fall back on the retrospective amendments brought in the shape of Explanation 4 and 5 of section 9(1)(vi) of the Act.

- Another significant element arising out of the decision is putting the decision of the Madras High Court in the case of Poompuhar Shipping Corporation Ltd.[6] and Verizon Communication (Singapore) Pte.[3] that dealt with consideration paid for use or right to use irrespective of whether there is transfer of a right, on a different footing. Significantly, the Tribunal has categorically given the finding that these decisions are not applicable as is evident from the substantial question of law formulated by the High Court for adjudication.

[5] Once taxpayer opts for the benefit of the tax treaty then there is no requirement for resorting to the definition and scope of 'royalty' as provided in section 9(1)(vi) of the Act. This proposition has been squarely covered in the decisions, DIT *v.* Nokia Network [2012] 253 CTR 417 (Del) and DIT *v.* Ericsson AB [2012] 343 ITR 470 (Del).

[6] Poompuhar Shipping Corporation Ltd. *v.* ADIT [2012] 24 taxmann.com 269 (Mad.)

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