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Retrospective amendment in domestic law cannot be read into tax treaty - payment for supply of software embedded in hardware not taxable as 'royalty' even after retrospective amendment

In brief

Recently, the Delhi High Court (HC) in the case of Nokia Networks OY[1], held that the consideration for supplying software (embedded in telecommunication GSM system) is not taxable as 'royalty' even after retrospective amendment to the Income-tax Act, 1961 (the Act) in terms of the India-Finland Double Tax Avoidance Agreement (the tax treaty or DTAA). It further held that clubbing of offshore supply and installation contract is not permissible. The revenue department's argument on applicability of 'look at' approach as enunciated by Vodafone International[2] ruling was not permitted due to difference in facts. The liaison office (LO) was held not to be a permanent establishment (PE) in absence of any adverse factual finding and question of subsidiary being PE remitted back to the Income-tax Appellate Tribunal (Tribunal) in light of certain factual errors.

Facts

- Nokia Networks OY (Nokia), a company based in Finland, was a leading manufacturer of advanced telecommunication systems and equipment (GSM equipment) which are used in fixed and mobile phone network.

[1] DIT *v.* Nokia Networks OY [TS-700-HC-2012 (Del)]

[2] Vodafone International Holdings BV *v.* UOI [2012] 341 ITR 1 (SC)

- In March 1994, Nokia opened a LO in India and subsequently incorporated a subsidiary Nokia India Pvt. Ltd (NIPL) in May 1995.
- Nokia supplied GSM equipment to various Indian telecom operators from outside the country on a principal-to-principal basis.
- The LO was carrying out advertising and other preparatory and auxiliary activities which were permitted by the RBI.
- Installation of the equipment supplied by Nokia was undertaken by its subsidiary NIPL under independent contracts with the Indian telecom operators.

Issues

- Whether Nokia had a PE or business connection in the form of LO and subsidiary in India?
- Whether any part of the consideration for the supply of software, stated by the assessee to be integral part of the equipment can be taxable as 'royalty' either under section 9(1)(vi) of the Income-tax Act (the Act) or the relevant provisions of the DTAA?

High Court Ruling

Whether payment of embedded software is 'royalty'

- The revenue department argued that retrospective amendments are clarificatory in nature and the question of use of 'copyrighted article' or actual copyright does not arise in case of software in light of the Delhi Tribunal ruling in the case of Gracemac Corp[3].
- The HC relying on the judgement of the Bombay HC in the case of Siemens Aktiongesellschaft[4] held that the amendment cannot be read into the treaty and in the case of Ericsson AB[5] it has already held that under the treaty, sale of a copyrighted article does not fall within the purview of royalty.

Whether LO constitutes a PE

- The HC held that the Tribunal in its order held that the LO had not carried out any business activity for the assessee in India and its role had been only to assist the assessee in the preliminary and preparatory work. Further, as per the rules of the RBI itself, LO is not permitted to carry out any business activity for a foreign enterprise. Its activities are closely monitored by the RBI and the latter had not found any violation of the rules under which the permission was granted to the LO.
- It further held that the revenue department could not satisfactorily explain how the findings of the Tribunal were perverse. Thus, the findings of fact by the Tribunal were final and cannot be interfered with. Thus, the HC concluded that the LO does not constitute a PE of Nokia in India.

Treatment of supply and installation contracts as composite agreement

- The revenue department argued that the supply contract between Nokia and Indian Telecom operator, installation contract between NIPL and Indian Telecom operator and marketing and support agreement should be treated as one composite agreement. Reliance was placed on the Supreme Court (SC)

[3] Gracemac Corp. *v.* ADIT [2010] 134 TTJ 257 (Del)
[4] CIT *v.* Siemens Aktiongesellschaft [2008] 310 ITR 320 (Bom)
[5] DIT *v.* Ericsson AB [TS-769-HC-2011 (Del)]

judgement in the case of Vodafone (above) to argue that intention of the parties must be examined on the basis of the express terms and conditions of the contract. It was also argued that the facts in the case of Ericsson AB (above) were different from this case.

- The HC, relying on the ruling of the SC in the case of Hyundai Heavy Industries[6] held that even in composite contracts offshore supply should be segregated. On the contrary, the revenue was trying to club different contracts, which was clearly impermissible.
- The HC further did not accept revenue department's reliance on Vodafone (above) ruling. It held that the revenue department had throughout maintained that the facts in the cases of Nokia and Ericsson AB (above) are similar, except for their submission on the taxability of royalty Income. Thus, it held that the reasoning given in Ericsson AB (above) ruling should apply.

Whether NIPL constitutes a PE and attribution of profit

- It was contended by the Nokia counsel that the Tribunal's conclusion of considering NIPL as a PE of Nokia was erroneous as it was based on various factual errors which crept in the order of the lower authorities.
- The HC held that the order of the Tribunal was based on many factual errors. The revenue department also could not controvert this aspect. Therefore, the matter was remanded back to the Tribunal for fresh consideration along with the issue of attribution of income.

Our comments

Taxability of software has been an issue of considerable debate and litigation across India. While the position of integrated supply of equipment and software was decided in favour of the taxpayer by the Delhi HC in the case of Ericsson ruling (above), revenue authorities were challenging its applicability after the retrospective amendments to the Income-tax Act, 1961. This is the first ruling by any HC after introduction of retrospective amendments, affirming the position that the tax treaty benefit will not be affected by the change in the domestic tax law. This will come as a relief to software vendors and connectivity service providers protected by tax treaties.

[6] CIT *v.* Hyundai Heavy Industries [2007] 291 ITR 482 (SC)

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