Indian distributor of airtime held to create a Dependent Agent PE of foreign channel owner in India

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In brief

In a recent ruling, the Mumbai Income-tax Appellate Tribunal (Tribunal) held, in the context of taxability of sale of advertisement airtime and channel distribution rights, that sale of Advertisement Airtime could not be classified as goods and the distributor was merely acting as the taxpayer's dependent agent, constituting a Dependent Agent Permanent Establishment (DAPE) in India. It observed, on the principle that no further attribution was possible if payments were at arm's length, that the same would be applicable only in respect of payments made by a foreign company to its Indian Associated Enterprises (AEs) in respect of services availed by it. On taxability of fee for granting Distribution rights, the matter was referred back to the Tax Officer (TO) to re-examine in light of definition of 'process' enacted under Explanation to section 9(1)(vi) of the Income-tax Act, 1961 (Act) and constitution of the taxpayer's PE.

In detail

Facts

- The taxpayer[1], a US incorporated entity, owned two television channels and broadcasted them in various countries, including in the Indian sub-continent.
- The taxpayer appointed N India as its distributor for channel distribution rights and for procuring advertisements for telecast on the channels, generating two streams of revenue as discussed below:
  - **Revenues from sale of Advertisement Airtime (Ad time)**

    The taxpayer executed 'Advertising Sales Representation Agreement' (Old Agreement) with N India on 1 July 2004 (w.e.f. 1 September 2004), appointing N India as their exclusive independent representative to solicit television advertising for its channels, and to collect and remit advertisement charges from Indian advertisers (net of commission @ 15% and taxes) to the taxpayer. This agreement was terminated and 'Advertisement Sales Agreement' (New Agreement) was entered into w.e.f. 1 May 2006, whereby, the taxpayer sold advertisement and sponsorship time on channels to N India for a fixed lump sum consideration.
  - **Fee for giving distribution rights for telecast of its channels (Granting channel distribution rights)**

    The taxpayer executed a "Distribution Agreement" dated 21 February 2001 with N India, granting the right to distribute a Channel to media intermediary subscribers in the Indian subcontinent, in consideration for an annual lump sum fixed fee.
- The taxpayer treated these incomes as business income and, in absence of a PE in India, did not offer these to tax in its return of

[1] TS-714-ITAT-2015(Mumbai – Tribunal)

income for the relevant period.

- The Transfer Pricing Officer (TPO) also accepted the Arm's Length Price (ALP) of international transactions entered into by the taxpayer with N India.
- The TO/ Dispute Resolution Panel held as under:
  - N India was a DAPE of the taxpayer. Therefore, it assessed 25.34% of the Advertisement revenues as income attributable to India, in the ratio of the taxpayer's worldwide profits to worldwide revenue, in accordance with Rule 10B(ii) of the Income-tax Rules.
  - Granting of channel distribution rights were in the nature of "royalty", and accordingly, assessed 15% of the amount paid as income as per Article 12 of India US Double Taxation Avoidance Agreement (India-US tax treaty).

Issues before the Tribunal

- Did the taxpayer constitute a PE in India in terms of India-US tax treaty, and consequently, was its revenue from advertisements was taxable in India?
- Did the income from distribution of channels fall within meaning of "Royalty" under Article 12 of India-US tax treaty and section 9(1)(vi) of the Act, and hence, was it also taxable in India?

Taxpayer's key contentions

I. On advertisement revenue

- Under the old agreement, N India was an agent of independent status, acting in its ordinary course of business. Its activities were not devoted wholly, or almost wholly, for the taxpayer. Even otherwise, commission paid to N India was also at arm's length, which the TPO had confirmed. Accordingly, NGC India should not be considered as dependent agent of the taxpayer.
- Under the new agreement, NGC India did not create a DAPE for the taxpayer mainly because:
  - The new agreement was entered into on Principal-to-Principal basis, and negotiated at arm's length. Hence, N India could not be considered to be the taxpayer's dependent agent.
  - Advertisement air time fell into the category of "goods", and hence it could be transferred like any other "goods".[2]
- Without prejudice, even if the taxpayer was presumed to have PE in India, advertisement revenue could not be taxed in India as per Article 7 of the India-US tax treaty, since such revenue could not be said to be effectively connected to the PE, as the advertisement airtime was sold by way of outright sale to N India. Therefore, no income could be said to arise economically from N India's business.

II. On revenue from grant of channel distribution rights

- The distribution right was a separate right in the nature of broadcasting reproduction right, which was different from copyright. Therefore, it was not covered in the definition of "Royalty" both, under the Act and under the India-US tax treaty.

Department's contentions

I. On advertisement revenues

- Ad time could not be delivered in advance; could not be used independent of the taxpayer; could not be stocked for future sale; and thus could not be considered as "Goods" capable of being sold.
- Advertisements procured by N India did not have any commercial value unless it was telecast, and hence the procurement of ad time was part of telecasting activity.
- The program, including advertisement, was uplinked by the taxpayer and was downloaded by cable operators for broadcasting. Thus, there was a direct relationship between the taxpayer and cable operators. Purchase, sales, delivery and consumption of advertisements were generated as well as concluded in India.
- There were no material changes in the taxpayer's rights and obligations under the old agreement (principal-to-agent) and under the new agreement (principal-to-principal). Accordingly, N India was held to be dependent agent in terms of paragraph 4(c) of Article 5 of the India-US tax treaty. Consequently, the taxpayer had a PE in India, as decided in a ruling of the jurisdictional bench[3].
- The ruling relied on by the taxpayer on attribution to PE, SET Satellite[4], was rendered considering Circular No. 23 of 1969, which had been withdrawn *vide* Circular dated 7 of 2009.
- Income attributable to PE had to be computed as per Rule 10B(ii) of Income-tax Rules, 1962 if separate

[2] Tata Consultancy Services *v.* State of Andhra Pradesh [2004] 271 ITR 401 (SC)

[3] ACIT *v.* DHL Operations B.V Netherlands [ITA No. 7987 and 7988/Bom/92]

[4] Set Satellite (Singapore) PTE Limited *v.* DDIT [2008] 218 CTR 452 (Bombay)

accounts for Indian operations were not available.

II. On revenue from grant of channel distribution rights

- N India was not free to make use of the channels as per its wishes, but strictly in accordance with terms laid down by the taxpayer. The taxpayer enjoyed the rights of an owner, whereas N India paid compensation for exploitation of the channels. Thus, the license fee payment made was covered within the definition of "Royalty".

Tribunal's ruling

I. On advertisement revenue

- Under the new agreement, the taxpayer sold advertising air time to N India for a fixed consideration. The ad time could not be classified as "Goods" as it was not capable of being consumed/ used independently, and had value only if the taxpayer telecast the advertisements. Involvement of the taxpayer till completion of telecast of advertisement material was essential to maintain the value of advertisement airtime.
- N India, by selling ad time, canvassed advertisements for telecast by the taxpayer in its television channels, thus establishing a relationship between the taxpayer and clients.
- In a principal-to-principal relationship in respect of sale of goods, the manufacturer did not come into the picture in respect of further sale of goods. In this case, ad time did not give right of universal use, and was restricted only to channels owned by the taxpayer. Hence, the taxpayer's involvement till completion of telecast of the advertisement material was essential to maintain the value of advertisement airtime. Hence, "advertisement airtime" could not be categorised as "goods".
- Following the principle of substance over form, by changing the agreement, the only change was the method of compensating N India, or method of generating revenue from broadcasting advertisements. Altering terms and conditions would not make it materially different from the old agreement.
- Based on certain clauses of the agreement, it held that N India exercised an authority to conclude contracts on the taxpayer's behalf, which was binding on the taxpayer. Hence, N India should be classified as Dependent Agent under Article 5(4)(a) of the India-US tax treaty. Thus, the taxpayer had a DAPE in India through N India for the assessment years (AYs) 2007-08 and 2008-09.
- Cases relied upon by the taxpayer on the principle of no further attribution where ALP was accepted, were distinguished on the ground that they would apply only in case of service arrangements where the foreign company was paying service fee to the Indian company, or where all activities related to the conclusion of contract took place outside India.
- Finally, the Tribunal restored the matter back to TO for the limited purpose of providing reasonable opportunity to the taxpayer to challenge the income computation mechanism, if required.

II. On revenue from grant of channel distribution rights

- 'Royalty' as defined in both, section 9(1)(vi) of the Act, and the India-US tax treaty, used the expression "process" which had not been defined in the India-US tax treaty. However, it was defined in Explanation 6 to sec. 9(1)(v) of the Act with retrospective effect, and therefore, it had to be applied.
- The Tribunal restored the matter back to the TO for the AYs 2007-08 and 2008-09 to examine whether the taxpayer fell under the ambit of 'Royalty' payment as per Explanation 6 of the Act, giving due consideration to the fact that the taxpayer was held to have a DAPE in India.

The takeaways

- Selling advertisement time through Indian companies is a common practice by global channel operating companies. Treating advertisement/ sponsorship time as 'goods' has been a subject matter of argument between taxpayers and the tax authorities, especially at the lower levels.
- Moreover, granting the authority to conclude contracts was driven by commercial requirements and industry practices. Whether mere grant of such right under the agreements for sale of advertisement airtime owing to commercial considerations should lead to

constitution of a DAPE in India, would need to be seen based on the specific facts of each case.

- The rulings also emphasised that the test of substance over form should be applied in looking at the essence of a transaction.
- The ruling may lead to further litigation on the principles for determination of DAPE in India, considering the earlier rulings on the issue in place.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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