Indian distributor of non-resident channel company not a PE; revenue from distribution of channels in India not taxable as royalty

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In brief

The Mumbai Income-tax Appellate Tribunal (Tribunal) recently analysed the taxability of income earned by a non-resident channel company from the distribution of channels in India, and held that the exclusive Indian distributor did not constitute an agency permanent establishment (PE) of the taxpayer in India. The Tribunal also held that the revenue received from distribution of channels in India did not amount to royalty under the India-Mauritius Double Taxation Avoidance Agreement (tax treaty).

In detail

Facts

- The taxpayer[1] was initially registered as a company in the British Virgin Islands. During the year, the taxpayer re-registered under the laws of Mauritius, and accordingly became a tax resident of Mauritius for part of the year.
- The taxpayer was engaged in the business of broadcasting a sports channel around the world, including India. The taxpayer had appointed its subsidiary in India (hereinafter referred to as the "Indian distributor") to undertake the following activities under two separate agreements:

  a) Act as the taxpayer's advertising sales agent to sell advertisement slots to prospective advertisers and other parties in India, and collect advertising revenue for a commission of 10% of the total advertisement revenue secured for the taxpayer; and

  b) Distribute pay channels to cable operators under a revenue share, where 40% of the total distribution revenue secured would be retained by the Indian distributor and the balance would be paid to the taxpayer as distribution income.
- The taxpayer filed its return of income in India without offering any income to tax in India, on the basis that the advertising and distribution revenue earned were not taxable in India in the absence of a PE.
- As an alternative, the taxpayer argued that as per the accounts pertaining to the India operations audited under section 44AB of the Income-tax Act, 1961 (the Act), losses had been incurred, and therefore, no income was chargeable to tax in India.
- The tax officer (TO) however held that the Indian subsidiary of the taxpayer was acting as an agent for the sale of advertisement slots to Indian advertisers. Hence, the Indian subsidiary was an agency PE of the

[1] [2016] 72 taxmann.com 143 (Mum)

taxpayer in India under Article 5(4) of the India-Mauritius tax treaty.

- In connection with the distribution income, the TO held the following:

  a) For the period during which the taxpayer was a resident of the British Virgin Islands, distribution income was taxable in India as royalty under section 9(1)(vi) of the Act; and

  b) For the period during which the taxpayer was a resident of Mauritius, distribution income was attributable to the PE and therefore chargeable to tax as business income under Article 7 of the India-Mauritius tax treaty.

- While computing the income attributable to the PE of the taxpayer in India, the TO disallowed the following payments made by the taxpayer to non-residents under section 40(a)(i) of the Act, for not withholding taxes, on the basis that such payments were chargeable to tax in India as royalty under section 9(1)(vi) of the Act:

a) Programming cost paid to cricket boards and other sports associations for acquiring live telecast rights for events outside India, holding it to be copyright in respect of the events;

b) Transponder fee paid for procuring services through satellite located outside India, holding it to be fee for use or right to use any industrial, commercial and scientific equipment; and

c) Uplinking charges paid for procuring services of uplinking signals from the venue of the live events taking place outside India to the satellite, holding it to be fee for use or right to use any industrial, commercial and scientific equipment.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the TO in terms of the taxability of advertisement revenue as business income. However, the CIT(A) held that the distribution income was not taxable in India. The CIT(A) reversed the disallowance made by the TO under section 40(a)(i) of the Act, as the payments made by the taxpayer were not chargeable to tax in India as royalty.

- The Revenue filed an appeal against the CIT(A)'s order *qua* distribution income and reversal of disallowances, while the taxpayer filed an appeal before the Tribunal *qua* the taxability of advertising income. There was a delay by the taxpayer in filing the appeal before the Tribunal in terms of advertising income that was not condoned by the Tribunal. Hence, the only issue before the Tribunal was with respect to the taxability of distribution income and disallowance of payments under section 40(a)(i) of the Act in arriving at the income taxable under Article 7.

Taxpayer's contentions

Distribution income

- The agreement between the taxpayer and the Indian distributor was on a principal-to-principal basis. The Indian distributor had obtained the right to distribute the channels in India from the taxpayer for its own business and had further entered into a contract with sub-distributors for the distribution of the channels to the end viewers. The taxpayer was not a party to the agreement between the Indian distributor and the sub-distributor. As per the sample agreement provided, the India distributor received 75% of the share in revenue from the sub-distributors.

- The Indian distributor was solely responsible for the marketing and promotion of services at its own discretion. Therefore, the Indian distributor was an independent contractor.

- For an enterprise to be regarded as agency PE under Article 5(4) of the India-Mauritius tax treaty, an agency relationship must exist, and the agent must habitually exercise the authority to conclude contracts in the name of the taxpayer. As mentioned above, neither did an agency relationship exist, nor did the Indian distributor enter into contracts in the name of the taxpayer.

- There was an inherent contradiction in the TO's order. For the initial part of the year (when the taxpayer was a resident of the British Virgin Islands), the TO had held that the income was chargeable to tax as royalty under the Act. For the latter part of the year (when the taxpayer was a resident of Mauritius), he held that the income was chargeable to tax as business income for the same distribution revenues. There could not be two different treatments of one income source.

- In any case, distribution income could not be charged to tax as royalty because under the agreement with the Indian distributor, the taxpayer had not granted any license to use any copyright. The distributor or the cable operator (i.e. sub-distributor) could not add, modify, delete or replace the contents of the channel transmitted to them. Therefore, distribution income could not be charged to tax as royalty under the Act. Reliance was placed on the decision in the case of Set India Pvt Ltd[2], MSM Satellite (Singapore) Pte Ltd[3].

Disallowances under section 40(a)(i) of the Act

- With respect to disallowances under section 40(a)(i), the taxpayer contented as follows:

  a) The taxpayer did not get any right to use the transponder, as it did not have physical control or possession over the transponder. The taxpayer also did not receive any knowhow in relation to the secret process of transmitting signals through the transponder. In any case, the recipient was not chargeable to tax in India under Article 12(7) of the India-USA tax treaty, as the US recipient did not have a PE in India. Also, the same was not chargeable to tax in India under Article 7 of the India-USA tax treaty, as the recipient did not have any PE in India. Reliance was placed on the decision of Set Satellite Singapore[4].

  b) Retrospective amendment to section 9(1)(vi) by the Finance Act, 2012 in relation to the definition of royalty could not be read into the India-USA tax treaty as the same had been defined therein. Reliance was placed on the decision of New Skies Satellite BV[5] and B4U International Holdings Ltd[6].

  c) Even on reading the retrospective amendments into the tax treaties, it was argued that disallowance under section 40(a)(i) of the Act could not be made because, at the time of making the payment, such income was not chargeable to tax based on judicial precedents. The taxpayer relied upon the decision in the case of Channel Guide India Ltd[7].

  d) The issue in connection with the disallowance of the programming cost had already been covered by the decision of the Mumbai Tribunal in the taxpayer's own case.

Revenue's contentions

Distribution income

- The entire distribution activity had been undertaken by the Indian distributor on behalf of the taxpayer in India. Therefore, the taxpayer had a PE in India under Article 5(4) of the India-Mauritius tax treaty.

- In any case, the distribution agreement involved full/ partial transfer of distribution rights, which was in the form of copyright and trademark. The taxpayer granted the cable operators use or access to the encrypted signal for commercial exploitation, which was the property of the taxpayer. Therefore, the distribution income was chargeable to tax in India as royalty under the Act. Reliance was placed on the decision in the case of NGC Network Asia LLC[8].

Disallowances under section 40(a)(i) of the Act

- With respect to disallowances under section 40(a)(i), the Revenue contented that payments made by the taxpayer to non-resident payees were chargeable to tax in India as per the retrospective amendment to section 9(1)(vi) brought about by Finance Act 2012, and also under Article 12(3)(b) of the India-USA tax treaty. Reliance was placed on the decision of Verizon Communications Singapore Pte Ltd[9] and Viacom 18 Media Pvt Ltd[10].

Ruling of the Tribunal

Distribution income

- In the absence of any material to the contrary, the Tribunal affirmed the view of CIT(A) that based on the distribution agreement and sub-distributor agreement placed on record, the Indian distributor was not acting as the taxpayer's agent.

- An agent could be said to be dependent if the commercial activity of the enterprise was subject to instructions or comprehensive control and if the enterprise did not bear entrepreneurial risk.

- An agency PE was established if the agent had sufficient authority to bind the foreign

[2] DDIT *v.* Set India Private Limited Mumbai Tribunal (ITA No 4372 / Mum / 2004)
[3] MSM Satellite (Singapore) Pte Ltd. [Mumbai Tribunal (ITA No 2870 / Mum / 2010 and ITA No 8478 / Mum / 2011)]
[4] DIT *v.* Set Satellite (Singapore) Pte. Ltd. [2014] 45 taxmann.com 100 (Bombay)
[5] DIT *v.* New Skies Satellite BV [2016] 68 taxmann.com 8 (Delhi)
[6] DDIT *v.* B4U International Holdings Ltd. [2012] 137 ITD 346 (Mum)
[7] Channel Guide India Ltd. *v.* ACIT [2012] 139 ITD 49 (Mum)
[8] NGC Network Asia LLC *v.* Jt. DIT [2015] 64 taxmann.com 289 (Mum)
[9] Verizon Communications Singapore Pte Ltd. *v.* ITO [2104] 361 ITR 575 (Madras)
[10] Viacom 18 Media (P.) Ltd. *v.* ADIT [2015] 153 ITD 384 (Mum)

enterprise's participation in the business activity. The Indian distributor did not constitute an agency PE of the taxpayer under Article 5(4) of the India-Mauritius tax treaty as it was acting independently *qua* the distribution rights, and the distribution agreement with the taxpayer was on a principal-to-principal basis.

- The TO's divergent views in terms of the distribution income taxable as royalty for part of the year and as business income for the other part of the year were not upheld.

- In any case, under the distribution agreement, the taxpayer had not granted any license to use any copyright to the Indian distributor or the cable operators. The taxpayer only made available the content to the cable operators that were to be transmitted to the end viewer, and the rights to such content belonged to the taxpayer. Therefore, distribution income could not be held as royalty. The decision in the case of NGC Network Asia LLC[7] could not be relied upon, as in that case, the issue of taxability of distribution income was set aside to examine whether it could be categorised as royalty. In the present case, the TO himself had treated the distribution revenue as business income for the latter part of the year and for subsequent years.

Disallowances under section 40(a)(i) of the Act

- Definition of royalty under the India-USA tax treaty was exhaustive and therefore no definition under the Act was required to be considered that extended the operation of the term defined in the India-USA tax treaty, whether prospective or retrospective. The legislature could not supersede or control the meaning of this term that has been expressly defined in the tax treaty negotiated between two sovereign nations.

- Transponder charges and uplinking charges paid could not be treated as consideration for use or right to use any copyright of a literary, artistic, or scientific work, including cinematographic films or work on film, tape or other means of reproduction for use in connection with the radio or television broadcasting or in any manner relates to any trademark, design, secret formula or process as required under Article 12 of the India-USA tax treaty.

- The Tribunal, following the decision in the case of New Skies Satellite[4], which had also taken into consideration the case of Verizon Communications Singapore Pte Ltd[8], held that the extended definition of royalty under the Act would not impact the interpretation of royalty under Article 12 of the India-USA tax treaty.

- In any case, the Tribunal relied on the legal maxim *"lex non cogit ad impossplia"* and held that the law could not possibly compel a person to do something impossible, that is, when there was no provision for taxing an amount in India, then tax could not be expected to be deducted on such payment. Therefore, retrospective amendment to the definition of the term "royalty" would not retrospectively affect the withholding tax obligations of the taxpayer. The Tribunal relied on the decision of Channel Guide India Ltd[6].

- The Tribunal relied upon the decision in the taxpayer's own case and held that the programming cost paid to foreign sports associations for events held outside India were not taxable in India, as the same could not be deemed to arise in India nor were they borne by any PE in India.

The takeaways

- The circumstances under which foreign channel companies were considered to have a PE/ business connection in India in terms of operations undertaken to distribute channels in India and sell ad airtime, have been contentious between the channel companies and Indian revenue authorities.

- The Tribunal, in the present case, based on the India-Mauritius tax treaty held that a foreign channel company did not have a dependent agent PE in India, as the group company appointed in India to distribute the channels was independent in its operations *qua* distribution activity.

- The Tribunal considered the distribution agreement (which is on a principal-to-principal basis) and the entrepreneurial risk borne by the Indian distributor to determine if the taxpayer has a PE in India. Though the judgement in case of NGC Network Asia LLC[7], where the facts were similar, and the Indian group entity was seen to constitute a PE, the Tribunal did not consider this case, since this matter was remanded back to the TO for further determination.

- The taxability of distribution income as "royalty" has been a subject matter of debate between foreign telecasting companies and the Indian revenue authorities. The

Tribunal has held that distribution income was not in the nature of royalty in case no rights in the content distributed had been transferred. Though the judgement in case of NGC Network Asia LLC[7] considered the same matter, the Tribunal did not place reliance on it, since this matter was remanded back to the TO to determine if distribution income qualified as "royalty". Separately, in terms of determining whether payment for transponder charges qualified as royalty, the Tribunal had relied on favourable judgements which held that the extended definition of royalty post the retrospective amendments would not impact the interpretation of royalty under the treaties. There were contradictory rulings on this matter. The Tribunal ruling in the present case could further strengthen the taxpayers' case.

Let's talk

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

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