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Retrospective amendment under the Act does not automatically alter the corresponding provisions under the tax treaty

In brief

In a recent decision of the Mumbai Income-tax Appellate Tribunal (the Tribunal) in the case of WNS North America Inc.[1] it was held (with regard to the retrospective amendment to the definition of 'royalty') that any amendment in the provisions of Income-tax Act, 1961 (the Act) does not have the effect of automatically altering the analogous provisions of the Double Taxation Avoidance Agreement (the tax treaty). If the retrospective amendment is in relation to a provision for which there is no contrary provision in the tax treaty, then such an amendment will have effect even under the tax treaty and *vice-a-versa*.

[1] WNS North America Inc. *v.* ADIT [TS-895-ITAT-2012(Mum)]

Facts

- WNS North America Inc. ('WNS Inc., USA' or 'the company' or 'the assessee) is a company incorporated in United States of America and is engaged in the business of providing software and IT enabled services to its clients located outside India.

- The assessee had entered into an agreement with WNS Global Services Pvt. Ltd. (WNS India) for providing marketing, management and sales support services (MM&S support services) which included identifying and meeting customers, building contacts and soliciting enquiries from them, appointing advertising agencies for the purpose of planning, preparing and executing advertising of WNS India's business.

- In respect of MM&S support services, the assessee received an amount of INR 369 million pertaining to services rendered outside India and INR 41 million was received towards services rendered in India.

- Pursuant to above agreement, employees of WNS Inc., USA visited India for rendering services to WNS India. Presence of such employees was deemed to constitute a service permanent establishment (PE) and profits attributable to such service PE were offered to tax in accordance with Article 5(2) read with Article 7 of the India-US tax treaty. Accordingly, the assessee submitted its tax return for assessment year (AY) 2006-07, declaring income of INR 24 million in connection with the service PE.

- The assessee also incurred international telecom connectivity charges/ lease line charges on behalf of WNS India. These charges were paid by the assessee to the service provider, in connection with services of domestic and international telecom operators utilised by WNS India for the purpose of transmitting data from WNS India to customers located outside India. This cost was reimbursed to the assessee on actual basis with no mark-up.

- During the course of assessment proceedings, the assessing officer (AO) made the following additions/adjustments to the income of the assessee, which was also confirmed by the Dispute Resolution Panel (DRP) :-

  - Marketing, management and sales support services to WNS India – treating the same as fees for technical services (FTS).
  - International telecom connectivity charges/lease line charges received by the assessee from WNS India – treating the same as royalty.

Aggrieved by the order of the DRP, the assessee appealed before the Tribunal.

Issues before the Tribunal

Issue I

The key issues raised before the Tribunal were:

a) Whether in view of insertion of Explanation 5 to section 9(1)(vi) of the Act with retrospective effect, the amount received by the assessee in respect of International telecom connectivity/lease line charges is taxable as 'Royalty' in terms of the India-US tax treaty

b) Whether the reimbursement (on cost-to-cost basis with no mark-up) of lease line charges/international telecom connectivity expenses can be treated as income in the hands of the recipient.

Issue II

Apart from the above key issues, the following issue was also in appeal before the Tribunal:

- Whether consideration in respect of MM&S support services (in India and outside India) is taxable as FTS as per Article 12(4)(b) of the India-US tax treaty.

The important observations of the Tribunal, in the captioned decision, in respect of the above key issues are discussed in this Alert. As regards the Issue II, since the same is a reiteration of earlier rulings, the observations of the Tribunal are only briefed.

Assessee's contentions

- Amount received represents cost-to-cost reimbursement of expenses incurred by the assessee for and on behalf of WNS India without any mark-up. Thus, the same cannot be treated as income for India tax purposes.

- Reliance was placed on the favorable decision of the Mumbai Tribunal (in assessee's own case) for an earlier year, on similar issue and facts wherein it was held that the payment in respect of lease line charges does not constitute royalty as it did not represent payment for the use of equipment and constituted pure cost reimbursement.

Revenue's contentions

- Owing to insertion of Explanation 5 to section 9(1)(vi) of the Act by the Finance Act, 2012 (with retrospective effect), the favorable order of the Tribunal for an earlier year, which was under the pre-amended erstwhile provisions of the Act, cannot be followed.

- Payment received represents consideration for the use of equipment which was in possession of the assessee and hence the amount represents royalty.

- Retrospective amendment to the provisions of the Act was relevant even for determining the taxability of an amount under the tax treaty.

- Lease line charges reimbursed are clearly covered by the definition of 'Royalty' as per clause (iva) of Explanation 2 and Explanation 5 to section 9(1)(vi) of the Act.

Tribunal Ruling

- Whether the retrospective amendment in the Act should be considered in interpreting the provisions of the tax treaty:

  - It was observed by the Tribunal that any retrospective amendment in the Act was to be followed from the date it comes into effect. Accordingly, the assessments and other proceedings under the Act have to move with the presumption of existence of such provision from the date it is deemed to come into effect.
  - If the retrospective amendment pertains to a provision for which there was no contrary provision in the tax treaty, then such amendment will have effect even under the tax treaty and *vice-a-versa*.
  - The retrospective amendment does not have the effect of automatically altering the parallel provisions of the tax treaty.

- The Tribunal relied on the decision of Supreme Court in the case of P.V.A.L. Kulandagan Chettiar[2] and the jurisdictional High Court decision in the case of Siemens Aktiongesellschaft[3] and concluded that an assessee can choose to be governed by the provisions of the Act or the tax treaty, whichever is more beneficial to him.

- A tax treaty cannot be altered by a country unilaterally and can be done only through the process of bilateral negotiations.

- An amendment to the definition of a term in the domestic law will not have any bearing on the interpretation of such term in the tax treaty, if it is specifically defined or whose meaning is not derived from the domestic law.

[2] CIT *v.* P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654 (SC)
[3] CIT *v.* Siemens Aktiongesellschaft [2008] 310 ITR 320 (Bom)

- There was no amendment in the tax treaty to bring the definition of Royalty at par with the amended definition under the Act. Therefore, the revenue's contention in this regard does not hold good.

- On the issue of whether reimbursement on cost-to-cost basis with no mark-up can be treated as income:

  - On merits of the case it was observed that the receipt can be taxed as Royalty only in the hands of the owner or lessor or any other person entitled to permit the use of equipment and earning income in his own right from allowing the use of such equipment to others. An intermediary, who makes payment to the owner of equipment on behalf of another person and then gets reimbursed for the payment, cannot be considered as an owner or lessor, etc. of the equipment so as to be covered by the provisions of section 9(1)(vi) of the Act. Hence, reimbursement by WNS India cannot be treated as royalty under the Act.
  - If there was no mark-up on reimbursements then there was no question of imputing any income on the same. The onus was however on the assessee to prove with sufficient evidence that reimbursement does not include any profit element.

In respect of Issue II - regarding MM&S support services, the Tribunal held that,

- The consideration received in this connection is not FTS in terms of Article 12(4)(b) of India-US tax treaty as the services did not 'make available' any technical knowledge, skill, etc. as envisaged by the tax treaty provisions.

- The amount received in respect of MM&S support services rendered in India is correctly treated as business income as per Article 7 of the India-US tax treaty

- The amount received in respect of MM&S support services rendered outside India does not accrue/arise or deemed to accrue or arise in India and hence was not taxable in India.

Conclusion

One of the important observations of the Tribunal in the above ruling is that the amendment in the Act does not automatically alter the analogous provisions of the tax treaty. With the retrospective amendment to the definition of 'Royalty' inserted by the Finance Act, 2012, the scope of 'Royalty' had widened. The tax authorities have the powers to reopen only those cases where the assessments have not been completed prior to April 1, 2012 or the notice of reopening the assessment has been issued prior to said date. In the absence of corresponding amendments in the tax treaty and the widening of the definition in the Act has led to doubts and insecurity in the mind of the taxpayers regarding the issue of taxation of royalty in cases where the withholding tax obligations have been discharged in the past under a *bona fide* belief that a particular payment is not 'royalty' as per the provisions of applicable tax treaty. This ruling provides clarity to the assessee and attempts to render certainty where the amount qualifies as 'Royalty' as per the provisions of relevant tax treaty.

In this context, it is important to refer to the recent decision of the Delhi High Court in the case of Nokia Networks OY[4] [TS-700-HC-2012] wherein it was held that payment for the supply of software embedded in the hardware is not taxable as a royalty under the relevant tax treaty even after retrospective amendment of the Act. It was observed by the Delhi High Court that the amendment in the domestic law cannot be read into a tax treaty.

[4] DIT *v.* Nokia Networks OY v. [TS-700-HC-2012]

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Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	**Bangalore** 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	**Bhubaneswar** IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	**Chennai** 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006 Phone +91-44 4228 5000	**Hyderabad** #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-33 2357 9101 / 4400 1111 Fax: (91) 033 2357 2754	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

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