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No disallowance of depreciation on brand items for not withholding tax

Disallowance on failure to withhold tax on royalty payment under section 40(a)(i) not applicable as it does not cover computer software referred to in Explanation 4 to section 9(1)(vi)

Background

In a recent ruling in the case of SKOL Breweries Ltd[1] (assessee), the Mumbai Income-tax Appellate Tribunal (Tribunal) held that the depreciation claimed on requisite cost of Brand under section 32 of the Income-tax Act, 1961 (the Act) is not hit by the provisions of section 40(a)(i) of the Act for not withholding of tax. Further, it was held that the payment made to an overseas affiliate for right to use of computer software though classified as Royalty under section 9 of the Act read with Explanation 4, the same cannot be disallowed under section 40(a)(i) of the Act, though no tax was withheld therefrom.

Facts

- The assessee is engaged in the business of manufacturing and sale of beer;
- The tax return submitted by the assessee was selected for scrutiny assessment proceedings;

[1] SKOL Breweries Ltd *v.*ACIT [TS-20-ITAT-2013(Mum)]

- During the course of the assessment proceedings, the assessing officer (AO) *inter-alia* proposed the following additions/ disallowances in the proposed draft order[2]:
  - Denial of depreciation claimed on purchase of Foster's Brand from Foster's Australia of INR 383,520,000
  - Payment to SABMiller A&A (Pty) Ltd (overseas affiliate) for accounting software classified as Royalty of Rs. 4,139,061
- On the proposed additions the assessee filed its objections before the Dispute Resolution Panel (DRP) that confirmed the proposed additions. Thereafter, the AO passed the final order in conformity with the DRP directions;
- The assessee filed an appeal before the Tribunal against the additions/disallowances.

Issues - I

Disallowance of depreciation claimed on purchase of Foster's Brand from Foster's Australia under section 40(a)(i) of the Act

Facts

- Assessee purchased Foster's brand from Foster's Australia for Rs. 1,679,592,000 and claimed depreciation on the same at 25% under section 32(1)(ii) of the Act;
- Foster's Australia approached the Authority of Advance Ruling (AAR) to determine as to whether the sale of Foster's Brand to SKOL is taxable in India or not;
- The AAR in its order dated 9 May, 2008 concluded that consideration received by Foster's Australia on sale of brand is taxable in India;
- The ruling pronounced by the AAR is currently contested by Foster's Australia before the High Court (HC) that has stayed the order of AAR by its interim order dated 22 September, 2008 and,
- The AO in the assessment proceedings of the assessee observed that since AAR has held that Fosters' Brand is taxable in India, the depreciation claimed by the Company on the same is not allowable as the assessee had failed to withhold tax at the time of remittance to Foster's Australia.

Issue before the Tribunal

- Whether depreciation claimed on brand capitalised under the head Fixed Assets schedule can be disallowed under section 40(a)(i) of the Act?

Assessee's contentions

- No liability to withhold tax arises in the hands of the company since the issue of taxability of Foster's brand in India has not crystallised as the matter is pending before the Delhi HC;
- Company is mandatorily required to claim depreciation as per Explanation 5 to section 32(1)(ii) of the Act
- No income accrues or arises in India on sale of equipment/trade mark/brand name
- Provisions of section 40(a)(i) of the Act are only applicable in case of revenue expenditure and not on capital expenditure

[2] The draft order also proposed several other tax additions (including transfer pricing adjustment)

- Reference made to various judicial pronouncements[3] of the Tribunal and HC wherein it has been held that provisions of section 40(a)(i) are not applicable on claim of depreciation under section 32 of the Act

Revenue's contentions

The company ought to have withhold taxes as per provisions of section 195 of the Act while making payment to Foster's Australia since the brand is taxable in India as held by AAR in the case of Foster's Australia

Tribunal ruling

- Restrained from giving a finding on the taxability of the Foster's Brand in India since the issue is sub-judice before the Hon'ble Delhi HC

- On alternative plea as to whether the provision of section 40(a)(i) of the Act are applicable to capital expenditure, it observed that provisions of section 40 of the Act of the Act begin with a *non obstant clause* and thus it has an overriding effect on the provisions of section 30 to 38 of the Act

- The Tribunal observed that the expression 'amount payable' as used in section 40 of the Act refers to an outgoing amount or expenditure incurred which is chargeable to tax and is subject to withholding tax. Further, it was observed that there is a distinction between expenditure incurred and other kinds of deduction which includes any loss incidental to carrying on business, bad debts, etc which are deductible.

- The provisions of section 40(a)(i) of the Act refers necessarily to outgoing amount and therefore necessarily refers to outgoing expenditure. Thus, depreciation being a statutory deduction it is obligatory on the part of the assessing officer to allow deduction of depreciation irrespective of any claim made by the assessee.

- Depreciation under section 32 of the Act is not in respect of the amount paid or payable which is subject to withholding tax but is a statutory deduction on an asset which is otherwise eligible for deduction of depreciation; and

- Reliance was placed on the ruling of Punjab and Haryana HC in the case of Mark Auto Industries[4] wherein it was laid down that provisions of section 40(a)(i) of the Act are applicable only in case of revenue expenditure and have no applicability in case of capital expenditure.

Conclusion

The Tribunal in its ruling clearly highlighted the distinction between the expression 'amounts payable' as used in section 40 and other kinds of deduction which are statutorily allowable and thus bringing to light on why provisions of section 40(a)(i) of the Act are not applicable on any capital expenditure incurred which is statutorily allowable.

Issue – II:

Payment made to SABMiller A&A (Pty) Limited towards Syspro License fees

Facts

- Assessee made payment of INR 4.14 mn to SABMiller A&A (Pty) Lted (a Group Company) towards Syspro license fees (accounting software)

[3] SMS Demag (P) Ltd *v* DCIT [2010] 38 SOT 496 (Del) and CIT *v* Mark Auto Industries [2011] 12 taxmann.com 259 (P&H)

[4] CIT *v* Mark Auto Industries [2011] 12 taxmann.com 259 (P&H)

- No taxes were withheld on payment made on account of Syspro license fees while making remittance for the same;

- The AO observed the payments towards Syspro License fees is in the nature of Royalty under section 9(1)(vi) of the Act and since the company has failed to withhold tax on the same, proposed to disallow the expenditure claimed by the company under section 40(a)(i) of the Act; and

Issue before the Tribunal

Whether payment towards Syspro License fees cannot be disallowed under section 40(a)(i) of the Act?

Assessee's contentions

- Payment made is only for use of copyrighted article and no copyright has been transferred, thus the same is not 'Royalty' under the India-South Africa tax treaty;

- Payment has been made as annual charges for up-gradation of syspro accounting software;

- Without prejudice to the fact that the said payment can be classified as Royalty, under Explanation 4 to section 9 of the Act then also the same cannot be disallowed under section 40(a)(i) of th Act since the definition of Royalty under section 40(a)(i) of the Act only covers Royalty as per Explanation 2 of section 40(a)(i) of the Act and does not cover within its ambit Royalty as per Explanation 4 of section 9(1)(vi) of the Act.

- Reference was made to the decision of the Tribunal in the case of Sonata Information Technology[5] where the Tribunal held that when Explanation 4 to section 9(1)(vi) has not been incorporated in definition of Royalty as provided under Explanation to section 40(a)(ia) of the Act then payment falling under Explanation 4 of section 9(1)(vi) of the Act would not attract provisions of section 40(a)(ia) of the Act

- Further, it is a case of reimbursement of expenditure on cost-to-cost basis without any income element being embedded therein and thus is not subject to tax under section 195 of the Act

Revenue's contentions

- The assessee made payment towards transfer of rights including the grant of license hence payment would be in the nature of Royalty under section 9(1)(vi) of the Act;

- Payment made for Syspro license is for right to intellectual property embedded in the software and thus the same is classifiable as Royalty

- Various judicial precedents were referred where it has been laid down that dictionary meaning of the term 'Royalty' includes payment made for use of specialised knowledge and thus payment made for accessing Syspro license software is Royalty; and

- Recipient has business connection in India and thus both income arising in India as well as outside India is taxable in India.

Tribunal ruling

- Rejected the contention that it is a case of pure cost-to-cost reimbursement since if such a plea of the assessee is accepted then the provisions of section 40(a)(i) can be circumvented by simply making payment to third party not directly but through intermediary and giving it the colour of reimbursement of cost to intermediary;

[5] Sonata Information Technology *v.* DCIT [2012] 19 ITR(Trib) 408 (Mum)

- Observed that the meaning of the term Royalty for the purposes of section 40 of the Act has to be as given under Explanation 2 to section 9(1)(vi) of the Act whereas payment for transfer of right or right to use of computer software is defined under Explanation 4 to section 9 of the Act as in the present case and thus no disallowance can be made under section 40(a)(i) of the Act;

- Reliance was placed on the decision of the coordinate bench in the case of Sonata Information Technology (above) where it was laid down that when the Royalty for transfer of right to use of computer software does not fall under Explanation 2 to section 9(1)(vi) of the Act but the same falls under Explanation 4 to section 9(1)(vi) of the Act. In view of the Explanation to section 40(a)(i) of the Act, the said amount cannot be disallowed under the provisions of section 40(a)(i) of the Act since definition of Royalty as per provisions of section 40(a)(i) of the Act only refers to Explanation 2 and not Explanation 4 to section 9 of the Act.

Conclusion

Taxability of software payments has been a contentious issue with the tax authorities. A recent development in this respect has been made with the legislature inserting Explanation 4 to section 9 of the Act to widen the scope and ambit of Royalty from retrospective effect. However, no such corresponding amendment has been brought in the definition of Royalty as per provisions of section 40(a)(i) which only refers to Explanation 2 and not Explanation 4 to section 9 of the Act. Thus, any payment made by the taxpayer to a non-resident payee which may be taxable under section 9(1)(vi) of the Act with Explanation 4 thereto would not warrant any disallowance for not withholding tax under section 40(a)(i) of the Act.

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