Reimbursement of data processing cost is not taxable as royalty under the Belgium tax treaty

1 April 2014

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Antwerp Diamond Bank NV1 (the taxpayer) held that payment made by the Indian branch to the foreign bank (HO) towards reimbursement of cost of data processing on a software installed by a foreign bank cannot be held as royalty under Article 12(3)(a) of the India-Belgium tax treaty (tax treaty). It was held that the branch does not have any independent right to use or control over the software installed on a server in Belgium, but it simply sends the data to the HO for getting it processed.

Further once the taxpayer has opted for the benefit of the tax treaty, there was no need to refer the definition and the scope of ‘royalty’ under Income-tax Act, 1961 (the Act). It was also held that the amendment made in the Act cannot be read into the tax treaty.

Facts of the case

- The taxpayer, a bank incorporated in Belgium, operating through branch in India. The HO of the taxpayer has acquired its main banking application software from an Indian software company. Subsequently, when the branch was set-up in India, the software license was amended to allow the branch to use same software by making it assessable through the server located at Belgium.

- The branch sends its data to the Belgium server from where the data gets processed as per the requirement of the banking operations. Since the branch was using the IT resources situated at Belgium, it reimburses the cost of the data processing to the HO on pro-rata basis for the use of the said resources.

- During the year under consideration, the taxpayer claimed HO expenditure of INR 12.41 million attributable to its banking business operations in India. These expenditure were classified as general administrative expenditure of INR 9.01 million and data processing cost of INR 3.40 million.

1 ADIT v. Antwerp Diamond Bank NV (ITA No. 347/Mum/2007) – Taxsutra.com
The taxpayer claimed that the general administrative expenditure as well as data processing cost, paid to the HO, were in the nature of reimbursement of expenditure. However, the Assessing Officer (AO) held that the taxpayer was providing services in the nature of commercial or scientific knowledge, to the Indian branch, which was in the nature of royalty and therefore, the taxpayer was required to deduct tax at source. However, since the taxpayer did not deduct tax, the payment would be disallowed under Section 40(a)(i) of the Act.

The Commissioner of Income-tax (Appeals) [CIT(A)] held that the data processing cost paid by the taxpayer to the HO does not amount to ‘royalty’ and, hence, there was no liability to deduct tax. Consequently, the payment cannot be disallowed under Section 40(a)(i) of the Act.

The CIT(A) held that the data processing cost of INR 3.40 million does not fall within the ambit of general administrative expenditure under Section 44C of the Act, because the data processing is an expenditure which is directly related to the business of banking and is, therefore, outside the purview of general administrative expenditure. Accordingly, such expenditure was allowed as business expenditure. However, CIT(A) held that the payment of INR 9.01 million are towards general and administrative expenditure, therefore the same will be allowed in accordance with the provisions of Section 44C of the Act.

Tribunal’s ruling

Taxability of royalty

Perusal of the agreement between the branch and HO indicates that only HO has the non-exclusive non-transferrable rights to use the computer software and it does not have any right to assign, sub-license or otherwise transfer the license. Therefore, the payment by the branch for use of computer software was not the right in the copyright but only for doing the work from the said software which subsist in the copyright of the software.

Perusal to the definition of royalty under Article 12(3)(a) of the tax treaty indicates that, when the payment of any kind is received as a consideration for the ‘use’ of or the ‘right to use’ of any of the copyright of any item or for various terms used in the said Article, then only it can be held to be for the purpose of ‘royalty’. The said definition of ‘royalty’ is exhaustive and not inclusive and, therefore, it has to be given the meaning as contained in the Article itself and no other meaning should be looked upon.

If the taxpayer is relied on the definition of royalty under the tax treaty, the definition and scope of ‘royalty’ given in the domestic law should not be read into or looked upon.

The character of payment towards royalty depends upon the independent ‘use’ or the ‘right to use’ of the computer software, which is a kind of copyright. However, in the present case, the payment made by the branch is not for ‘use’ of or ‘right to use’ of software which is being exclusively done by the HO only. The branch sends the data to the HO for getting it processed and it was reimbursing the cost of processing of such data to the HO on pro-rata basis.

It is not the case of the tax department that the HO has provided any copyright of software or any copyrighted article developed by the HO for the exclusive use of the taxpayer for which the taxpayer is making the payment along with the mark-up exclusively for the purpose of royalty.

If the payment for license of the software which is installed in the HO is being made by the HO, then any allocation of cost and reimbursement thereof by the branch to the HO cannot be termed as independent payment for the purpose of royalty.

To fall within the definition of royalty under the tax treaty, the payment should be exclusively qua the use or the right to use the software exclusively by the branch. The character of the payment under the royalty transactions depends upon the rights that the transferee acquires in relation to the use and exploitation of the software programme. In the present case, there was no such right has been acquired by the branch in relation to the usage of software, because the HO alone has the exclusive right of the license to use the software.

The conclusion drawn by the Mumbai Tribunal in the case of Kotak Mahindra Primus Ltd. is applicable to the facts of the present case.

The decisions of the Madras High Court in the case of Poomphor Shipping Corporation and Verizon Communication Singapore Pte. Ltd. are not applicable to the facts of the present case because once the taxpayer has opted for the benefit of the tax treaty, there was no need to refer the definition and the scope of ‘royalty’ under Section 9(1)(vi) of the Act. The said amendment cannot be read into the tax treaty as given in Article 12(3) of the tax treaty. In order to support its stand, the Tribunal relied on various decisions.

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1 Kotak Mahindra Primus Ltd. v. DDIT [2007] 11 SOT 578 (Mum)
2 Poompuhar Shipping Corporation Ltd. v. ITO [2014] 360 ITR 257 (Mad), Verizon Communication Singapore Pte Ltd. v. ITO [2013] 263 CTR 497 (Mad)
3 CIT v. Siemens Aktiengesellschaft [2009] 310 ITR 320 (Bom)
4 CIT v. Ericsson AB [2012] 343 ITR 470 (Del)
Accordingly, it has been held that the payment made by the branch to the HO towards reimbursement of cost of data processing cannot be held to be royalty under Article 12(3)(a) of the tax treaty. Consequently, there was no requirement to deduct tax on such payment and therefore, the disallowance under Section 40(a)(i) of the Act will not apply.

**Clubbing of data processing expenditure along with the general administrative expenditure**

- Perusal of the various decisions\(^5\) indicates that the HO expenditure are restricted to executive and general administrative expenditure only, as defined in Explanation (iv) to Section 44C of the Act.

- The data processing cost pertains to allocation of expenditure incurred by the HO on pro-rata basis for the banking application software acquired by the HO. Such expenditure does not fall within the meaning of 'Head Office Expenditure' as provided in Section 44C of the Act. The nature of expenditure as given in Section 44C of the Act has to be necessarily in the nature of executive and general administrative expenditure only.

- Accordingly, while relying on various decisions\(^5\), the Tribunal upheld the CIT(A)’s order where it was held that the data processing cost does not fall within the ambit of general administrative expenditure under Section 44C of the Act and such expenditure was allowed as business expenditure. Further the balance payment towards general and administrative expenditure, were allowed in accordance with the provisions of Section 44C of the Act.

**Our comments**

This is a welcome ruling of the Mumbai Tribunal where it has been held that payment made by the Indian branch to HO towards reimbursement of cost of data processing on a software installed by a foreign bank cannot be held as royalty under the India-Belgium tax treaty because the branch was not having any independent right to use or control over the software installed on a server in Belgium, but it simply sends the data to the HO for getting it processed.

Further the Tribunal held that retrospective amendments introduced in Section 9(1)(vi) of the Act do not affect taxation of software where a favourable tax treaty applies. The Tribunal has held that the amendment made by the Finance Act, 2012 cannot be read into the definition provided under Article 12(3) of the tax treaty.

\(^5\) IAC v. Goodricke Group Ltd [1985] 12 ITD 1 (Cal) (SB)
DDIT v. Stock Engineer and Contractors B.V. [2009] 27 SOT 452 (Mum)

\(^6\) Section 9(1)(vi) of the Act has been amended by the Finance Act, 2012 with retrospective effect from 1 June 1976
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