



Royalty income, not being effectively connected with a PE (branch office) in India, is taxable on a gross basis under the India-Italy tax treaty

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Iveco Spa¹ (the taxpayer) held that to effectively connect royalty with a Permanent Establishment (PE) one has to evaluate the 'asset test' and to effectively connect Fees for Technical Services (FTS) with PE one has to evaluate 'activity test' or 'function test'. Since these tests are not satisfied, the royalty income received by the taxpayer is not effectively connected with its Branch Office (BO) in India. Therefore, royalty income is taxable at 20 per cent on a gross basis under the India-Italy tax treaty (the tax treaty).

The Tribunal observed that since employees of the Indian BO of the non-resident company were neither capable nor engaged in the performance of the contract, the activities of the contract were not effectively connected with BO.

Facts of the case

- The taxpayer is an Italian company and has set-up the BO with the permission of the Reserve Bank of India (RBI).
- The Indian activities of the BO consisted of undertaking business development and liaisoning activities, assisting the taxpayer in obtaining necessary approvals from various regulators, assisting the taxpayer in its global purchasing activities, sourcing engines locally for exporting them to the taxpayer's dealer and customers outside India, etc. These activities were permitted by RBI in response to the application for setting up

the branch office in India. As per the RBI permission, BO shall not undertake local buying and selling in India and retail trading in India.

- The taxpayer has entered into an agreement with New Holland Tractors India Private Limited (New Holland Tractors) for Technical Collaboration and License Agreement (TCL agreement) for providing the right to assemble diesel engines and its parts in India.
- The taxpayer received royalty income in India from New Holland Tractor and offered the same to tax as royalty in terms of Article 13 of the tax treaty, chargeable to tax thereon at the rate of 20 per cent on a gross basis. The taxpayer claimed that this income was received by the head office of the Indian branch directly.
- On perusal of the terms of the agreement, the Assessing Officer (AO) observed that the taxpayer's personnel are constantly present in India and are providing technical support services. Also, BO is employing around 25 employees who are equipped to render services, which are mandated under the contract and further they are providing business development services. Consequently, the services are being provided through BO, and thus the royalty income is 'effectively connected' to the PE of the taxpayer i.e. BO. Accordingly, AO passed draft assessment order, treating such sum as business income taxable at the rate of 41.82 per cent.

¹ Iveco Spa v. ADIT [ITA No. 5447/Del/2010 (AY: 2007-08), ITA No. 5696/Del/2012 (AY: 2009-10)]

- Based on the direction of the Dispute Resolution Panel (DRP), AO passed the final order under Section 143(3) of the Act, treating the royalty income as 'effectively connected' to the PE and chargeable to tax at the rate of 41.82 per cent on a gross basis.

The Tribunal's ruling

- The taxpayer has a PE in India as a BO, and the taxpayer has earned 'royalty' in India, which falls under Article 13(3) of the tax treaty. According to Article 13(5) of the tax treaty, if the right, property or contract in respect of which royalty is earned is effectively connected with the PE of the taxpayer then the taxpayer losses concessional treatment provided in Clause 1 and 2 of Article 5 of the tax treaty.
- The claim of the tax department is that the services as per the agreement wherein certain technical support services and training is provided, is allegedly provided by the employees of BO of the taxpayer in India. The income by way of royalty is effectively connected with the contract generating the royalty hence; taxpayer is not entitled to concessional treatment as per Clause 1 and 2 of the Article 13 of the tax treaty.
- The taxpayer has provided the information that three of the employees of taxpayer visited India from Italy, and provided the needful support and training to the Licensee, and none of them stayed in India for more than 90 days. No services have been provided by the employees of BO of the taxpayer in India. Therefore, the tax department's stand that the taxpayer has not provided the details of the persons who provided services in connection with that agreement is incorrect.
- Further, it is also not brought on record by the tax department that during the year any services were in fact provided by the taxpayer to the Licensee. Revenue has not made any inquiry with the Licensee about the nature of services provided by the taxpayer during the year and who are the persons who provided these services. In the absence of this inquiry and material on record, and in view of the affirmative statement by the taxpayer at all stages that employees of BO of the taxpayer are neither capable nor engaged in performance of the contract, it is held that the activities of the contract are not effectively connected with BO of the taxpayer.
- The contention of AO and DRP is that the services to be provided, by the taxpayer to New Holland Tractors are sophisticated and in the absence of support of employees of BO, could not have been accomplished. Since BO employs technically qualified staff, it is inferred by the tax department that employees of BO have provided these services.
- Prior to this agreement, the taxpayer had such technical agreement with another party in India and at that time the branch office of India did not exist. By merely having some staff with its BO, that are technically qualified, it cannot be inferred that they have provided services for performance of the impugned contract.
- The services rendered by BO, which are tabulated in the letter of permission of the RBI, are also technical in nature, which, inter alia, includes providing technical support services to the clients of its HO in India, after sales support services, warranty services, etc. Therefore, to perform such activities, BO of the taxpayer in India needs technically qualified employees. No presumption can be drawn by the tax department regarding the involvement of PE in earning royalty income.
- To effectively connect royalty with a PE one has to evaluate the 'asset test' and to effectively connect FTS with PE one has to evaluate 'activity test' or 'function test'.
- In the present case, the sum is offered and accepted for taxation as royalty, then for evaluation of its effective connection with the PE only 'assets test' should be applied, which fails miserably.
- Assuming that sum is FTS, even then, the 'activity test' or 'function test' is also not satisfied.
- To 'effectively connect' this royalty income with PE, the tax department should establish that
 - PE should be engaged in the performance of technical services or should be involved in the actual rendering of such services.
 - It should arise because of the activities of PE.

- The PE should, at least, facilitate, assist or aid in the performance of such services, irrespective of the other activities PE performs.
- In substance, neither there is any material about the requirement of the services by the recipient of the services nor provision of such services, if any, by the employees of BO of the taxpayer. Therefore, in the absence of any such material, the income of royalty is not the income arising out of results of the activities of the PE. The income of royalty is because of the direct dealing of the New Holland Tractors with the taxpayer without the aid or support from its PE in India.
- Thus, the royalty income received by the taxpayer is not effectively connected with its BO in India, and therefore, in terms of Article 13(5), the taxpayer is entitled to preferential tax treatment as per Article 13(1) and (2) of the tax treaty.
- Royalty income earned by the taxpayer on account of technical agreement with the New Holland Tractors is not effectively connected with BO of the taxpayer in the absence of any positive and substantive material that services have been rendered by the employees of BO of the taxpayer, and therefore, same is chargeable to tax as 'royalty' income as per Article 13(1) and (2) of the tax treaty.

Our comments

Taxability of the royalty income of a foreign company vis-à-vis its effective connectivity with a PE in the form of a BO, project office, etc. is a subject matter of litigation before the Courts/Tribunals. In the present case, the Tribunal held that by merely having technically qualified staff with the Indian branch, it cannot be inferred that they have provided services for performance of the impugned contract. To 'effectively connect' the royalty income with PE, the PE should be engaged in the performance of technical services, or at least, facilitate, assist or aid in the performance of such services, irrespective of the other activities PE performs. Therefore, royalty income is taxable at 20 per cent on a gross basis under the tax treaty.

This decision may impact foreign companies having PE in India and also earning other income such as royalty, FTS, etc. which are not effectively connected with their PE in India. This decision is based on specific facts of this case; therefore, it is important to consider facts of each case before applying this decision.



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