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Global Tax Insights

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COUNTRY FOCUS

INTERNATIONAL TAX CASES

EDITORIAL

In all my previous editorials I had been sharing the extensive work being done by the Organisation for Economic Co-operation and Development (OECD) under the Base Erosion and Profit Shifting (BEPS) project. Discussion drafts have been released on Action 4 – Interest deductions; Actions 8, 9 and 10 – Risk, re-characterisation; Action 10 – Profit splits and cross-border commodity transactions; and Action 14 – Making dispute resolutions more effective.

The discussion draft on Action Plan (AP) 10 on 'Low value-adding intra-group services' tries to address the concern of the tax authorities that cross-charges are increasingly used by taxpayer groups as a means to optimise their tax liability across the globe. Accordingly, with a view to balance the need for charging low value-adding intra-group services and the concern of the tax authorities, the discussion draft suggests the following simplified approach:

- Identifying a wide category of common intra-group services fees commanding a very limited profit mark-up on costs
- Applying a consistent allocation key for all recipients
- Providing a framework for identifying the low value-adding intra-group services and appropriate mark-ups for the services
- Providing guidance on shareholder activities and duplicative costs together with a simplified benefit test for the low value-adding intra-group service
- Providing transparency through specific reporting requirements, including documentation showing the determination of the specific cost pool.

The discussion draft provides welcome guidance by providing a definition of 'low value-adding intra-group services'. These services are defined as 'those services that are supportive in nature, not forming part of the core business of the MNE group and which do not require the use of unique intangibles and does not assume substantial or significant risks'. Once finalised, this AP will go a long way in reducing litigation on this contentious issue.

This edition of the newsletter, besides the updates from various countries, incorporates two judgements: one from the Court in Israel and the other from the Tribunal in India.

I express my gratitude to all member firms that have contributed to this edition of the newsletter. I sincerely hope that the contents are useful to members and their clients. Feedback and suggestions on the contents are always welcome. You may email your suggestions to sachin@scvasudeva.com.

Happy reading!

Sachin Vasudeva
Senior Partner, S.C. Vasudeva, India

GERMANY *Contributed by Heike Schneemann, Audit Tax & Consulting Services GmbH*

Taxation of interest income from loans of a foreign partner in a German partnership

The Federal Fiscal Court has referred the following question to the German Federal Constitutional Court: Is the statutory provision of Section 50 para. 10 of the German Income Tax Act in accordance with the German constitution?

What is it all about?

A partner of a German partnership, resident in Italy, granted a loan to its German partnership. The interest income earned was sought to be taxed in Italy (rather than in Germany), which was refused by the German tax authorities with regard to the provision in Section 50, para. 10 of the German Income Tax Act.

According to the double taxation agreement (DTA) with Italy, interest income in the case of an Italian resident lender is to be taxed in Italy. However, Section 50 para. 10 of the German Income Tax Act somewhat overrides this regulation and determines that interest income of a partner in a German partnership is to be classified as corporate income rather than interest income, and as such is subject to German taxation. This would mean that the interest income would be taxed twice in the end: as business income in Germany, and as interest income in Italy!

According to the German tax authorities, the regulation in Section 50 para. 10 of the German Income Tax Act should not be considered as a so-called 'treaty override'. To ensure uniformity with the taxation of domestic and foreign shareholders, this Regulation was considered necessary, as for a resident partner such income is taxed as business income.

Decision of the Federal Court of Finance

In contrast to the German tax authorities, the Federal Court of Finance considers the said Regulation as a 'treaty override'.

Even though it seems that the German legislature wanted to treat domestic and foreign partners in an equal manner, it violates the basic principle of avoiding double taxation by two different legislations.

The Federal Court of Finance in this context referred to the fact that the German legislature has recognised this underlying problem. Appropriate special clauses have been inserted into the DTAs with a number of other states (e.g. in the agreement with Switzerland; and with Algeria, Austria, Belarus, Ghana, Kazakhstan, Singapore, Tajikistan, Uzbekistan and Uruguay).

As Germany has not included a similar clause in the DTA with Italy, the Federal Court of Finance has taken the view, that the existing regulations between Germany and Italy allow no room for such an interpretation of the DTA.

With some kind of 'repair law' in Section 50 para. 10 of the German Income Tax Act (effective as of 1 January 2013), the German legislature has indeed created a possibility for German income taxes to be credited against the respective income taxes paid in Italy. But in the opinion of the Court, that does not change the violation of the international regulations of the DTA, especially as the above regulation is not applicable for trade tax purposes.

The Court further emphasised that Germany could easily have changed the DTA by giving notice of at least 6 months to the end of a calendar year.

Conclusion

If the German Constitutional Court decides that such 'treaty overrides' are violating the German Constitution, then German tax law will change fundamentally.

INDIA *Contributed by Ashish Gupta, S.C. Vasudeva & Co.*

Important changes proposed by the Union Budget 2015

The Union Budget 2015 was tabled in Parliament on 28 February 2015. The major changes proposed concerning international taxation are detailed below.

Provisions relating to indirect transfer

As per Section 9(1) of the Income Tax Act, 1961 ('the Act'), the following income shall deemed to accrue or arise in India: 'All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or **through or from any asset or source of income in India**, or through the transfer of a capital asset situated in India.'

An explanation was inserted in Section 9(1) of the Income Tax Act, 1961 by the Finance Act, 2012, which states that: '**an asset or capital asset** being any share or interest in a company or entity registered or incorporated outside India **shall be deemed to be situated in India** if the share or interest **derives, directly or indirectly its value substantially from the assets located in India**.'

The word 'substantially' was not defined in the Act. The Budget 2015 proposes to explain the word 'substantially' so as to provide clarity for investors. The explanation mentioned below is proposed to be inserted by the Finance Act, 2015, to clarify that when a share or interest in a company is deemed to be deriving its value from assets located in India:

i. The share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets:

   a. exceeds the amount of 10 crore rupees; and

   b. represents at least 50% of the value of all the assets owned by the company or entity.

ii. Value of an asset shall mean the fair market value of such asset without reduction of liabilities, if any, in respect of the asset.

iii. The specified date of valuation shall be the date on which the accounting period of the company or entity, as the case may be, ends preceding the date of transfer.

iv. However, if the book value of the assets of the company on the date of transfer exceeds by at least 15% of the book value of the assets as on the last balance sheet date preceding the date of transfer, then instead of the date mentioned in point iii, the date of transfer shall be the specified date of valuation.

v. The manner of determination of fair market value of the Indian assets vis-a-vis global assets of the foreign company shall be prescribed in the rules.

vi. The taxation of gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be on a proportional basis. The method for determination of proportionality is proposed to be provided in the rules.

vii. The exemption shall be available to the transferor of a share of, or interest in, a foreign entity if it, along with its associated enterprises:

   a. neither holds the right of control or management,

   b. nor holds voting power or share capital or interest exceeding 5% of the total voting power or total share capital, in the foreign company or entity directly holding the Indian assets ('direct holding company').

viii. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly then the exemption shall be available to the transferor if it, along with its associated enterprises:

   a. neither holds the right of management or control in relation to such company nor the entity,

   b. nor holds any rights in such company which would entitle it to either exercise control or management of the direct holding company or entity or entitle it to voting power exceeding 5% in the direct holding company or entity.

ix. Exemption shall be available in respect of any

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transfer, subject to certain conditions, in a scheme of amalgamation, of a capital asset, being a share of a foreign company which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the amalgamating foreign company to the amalgamated foreign company.

x. Exemption shall be available in respect of any transfer, subject to certain conditions, in a de-merger, of a capital asset, being a share of a foreign company which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the demerged foreign company to the resulting foreign company.

xi. There shall be a reporting obligation on Indian concern through or in which the Indian assets are held by the foreign company or the entity. The Indian entity shall be obligated to furnish information relating to the offshore transaction having the effect of directly or indirectly modifying the ownership structure or control of the Indian company or entity. In case of any failure on the part of Indian concern in this regard, a penalty shall be leviable. The proposed penalty shall be:

    a. a sum equal to 2% of the value of the transaction in respect of which such failure has taken place in case where such transaction had the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern; and

    b. a sum of 500,000 rupees in any other case.

Reduction in withholding tax rate of royalty and fees for technical services in case of non-resident

It is proposed to reduce the rate of tax provided under Section 115A of the Act on Royalty and Fees for Technical Services paid to non-residents from 25% to 10%. This amendment will bring the rates of withholding tax at par with the treaty rates.

Residential status of a foreign company

It is proposed to amend the provisions of Section 6 of the Act, to provide that a company other than an Indian company shall deemed to be resident in India in any previous year, if 'its place of effective management, at any time in that year, is in India'.

'Place of effective management' means 'a place where key management and commercial decisions that are necessary for the conduct of the business of an entity **as a whole are, in substance made**'.

The proposed amendment, if approved in its current form, could create difficulty for foreign subsidiaries of Indian companies. It is common knowledge that key decisions of foreign subsidiaries are usually taken in India. That being the position, the income of the foreign subsidiary could get taxed in India.

NEW ZEALAND *Contributed by Phil Barlow, Hayes Knight New Zealand*

The net has been widened on who is a New Zealand tax resident

Tax residency determines whether an individual will be taxed only on their New Zealand-sourced income or on their worldwide income.

An individual is treated as New Zealand tax resident if:

- They have a permanent place of abode in New Zealand; or
- They are present in New Zealand for more than 183 days in total in a 12-month period (the individual is treated as being resident from Day 1).

A person will generally lose their New Zealand tax residency if they are outside New Zealand for more than 325 days in any 12-month period and cease to have a permanent place of abode.

Emphasis is now placed on whether or not a person has a dwelling available to them in New Zealand. If they do, then this will more than likely satisfy the 'permanent place of abode' test. This represents a significant shift from the historical position, and as a result has widened the net of who is a 'tax resident'.

Historically, whether a person had a permanent place of abode or not could be quite ambiguous. A number of factors needed to be considered – such as family and financial connections, location of personal possessions, memberships – with little guidance on how many, or which, factors gave rise to an individual having a permanent place of abode.

New interpretation

The Inland Revenue's view now is that you only need to consider whether a person has a permanent place of abode if the individual has a dwelling in New Zealand. If the individual does have a dwelling in New Zealand, you still need to consider other factors to determine whether a permanent place of abode exists.

The dwelling does not need to be readily or exclusively available to the individual at all times – so an available dwelling can include a New Zealand property that has been rented out; it could be the home of a parent, friend or relative; it could even be a property held in a trust. The Inland Revenue's view is that a dwelling is a place with which the person has an enduring or significant connection, and from which they could continue their normal daily life. Ultimately, this will be a question of fact.

For those individuals who don't have a dwelling in New Zealand, there can be no permanent place of abode, regardless of whether other factors are present. This has provided advisors and taxpayers with greater clarity on the residency rules.

Who does this impact?

This new interpretation of permanent place of abode will impact individuals who have left New Zealand and have retained a property that is rented to tenants. It may result in the individual, unintentionally, retaining a permanent place of abode in New Zealand and therefore remaining a New Zealand tax resident (and ultimately being taxed in New Zealand on their worldwide income).

The Inland Revenue's interpretation of the permanent place of abode test is not well supported by case law. Historically, most residency cases have considered the availability of a dwelling as only one of a number of factors requiring consideration.

The Commissioner's interpretation of what constitutes an available dwelling is problematic. Fixed-term tenancies are considered unavailable, while periodic tenancies are considered available. Assuming a regular arm's-length periodic tenancy agreement, it is difficult to understand or accept how the dwelling remains available to the owner.

Overall, it appears that the Commissioner's interpretation is strained and at odds with flavour of the commentary contained in the latest Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, and represents a change from the approach previously adopted by the Inland Revenue.

Historically, the Inland Revenue has followed the OECD's commentary, in that once a person has been out of a country for at least 3 years, then they were

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considered non-tax residents of that country. This approach will no longer be followed. If an individual has a dwelling in New Zealand to which they have a significant and enduring connection, then they are likely to be considered as having a permanent place of abode.

On a practical note, the issue is more problematic for individuals receiving income from a low-tax or no-tax jurisdiction. Generally, a foreign tax credit could be claimed in the individual's New Zealand tax return in respect of foreign tax already paid (thus avoiding double taxation). This foreign tax credit would be minimal or nil if the income was sourced from a low-tax or no-tax jurisdiction, so the widening of the tax residency net is more an issue for these individuals.

Individuals who have already paid tax overseas at New Zealand equivalent tax rates, and are caught by the new interpretation of permanent place of abode, will simply have a compliance obligation in New Zealand to file a tax return; no further New Zealand tax should be payable.

Individuals living outside New Zealand but who have a property in New Zealand should ensure they seek sound New Zealand tax advice to ensure their compliance obligations are being met.

PERU *Contributed by Gonzalo Sánchez, Quantum Consultores*

Tax deductions on public works

With the aim of ensuring that Peru's economic growth is sustainable over time, and to help generate wealth and social well-being, the Peruvian Congress has enacted a piece of legislation called 'Law to boost both Regional and Local Investment in the private sector which includes the investment mechanism of a tax deduction on public works'.

Under this newly enacted law, investors in public infrastructure (hospitals, schools, water treatment plants, energy and telecommunications projects, etc.) are entitled to an income tax credit on the costs and expenses incurred.

The main features of this new law are explained below.

Features of the tax benefit

The investment mechanism 'Public Deduction on Public Works' is an incentive for the private sector to engage in Peru's development initiatives, as it encourages the joint work of local and regional governments, public universities, facilitating 'first-priority' projects of public interest.

The immediate implementation of such projects is carried out with a charge to the income that subnational governments and public universities are entitled to receive from the Central Government over a period of 10 years. That is, the subnational governments and public universities pay no financial interest on account of their canon, royalties, rentals customs duties and share capital for up to 10 years after the project or work is completed. Meanwhile, investors (private companies) prepay their income for the amount involved in first-priority projects such as health care, education, utilities (water and sewage), road infrastructure, irrigation infrastructure, energy and telecommunications, tourism and leisure. This investment is a credit against income tax payable in the following year; such tax credit can reach up to 50% of total income tax.

Requirements to apply for tax credit

To enjoy the credit, companies must finance the prioritised project under the provisions of Law 29230 and its regulation. To this end, they should first take part in the selection process. Companies must meet legal, economic and technical requirements as stated in the 'Tender Selection' criteria. Those companies that are under any of the impediments to be a bidder and/or contractor, as established in the Law on Government Procurement, may not take part in the selection process.

Once the investment project is completed and its reception and quality is approved, a 'Certificate of Regional and Local Public Investment – Treasury' (CIPRL) is issued, which supports credit against income tax.

It is possible to request a further certificate to be issued for 2% of CIPRL not entirely used, without affecting the previous CIPRL credit. Such a benefit is not income taxable and does not apply to beneficiary companies that had not determined tax during the previous year.

Conclusion

The tax benefit 'Tax Deduction on Public Works' is based on efficient synergies between the private sector and subnational governments and public universities. These synergies enable private companies to invest in public investment projects with social impact, for the added incentive that the related costs and expenses can be used as a tax credit.

The main advantage of tax benefit is the rapid implementation of the first-priority project, run by the private sector, for the interest and well-being of the most deprived social sectors; at the same time, it has a positive impact on the finances of the companies involved.

Yael Tzur v. Income Tax Assessor Income Tax Appeal no. 19466-01-12 (21 October 2014)

Ariel Zitnitski, Zitnitski Weinstein & Co.

This case deals with the issue of whether the taxpayer was an 'Israeli resident' while working in Hong Kong and whether her income from working in Hong Kong should be taxable in Israel.

Facts of the case

Yael left Israel to live in Hong Kong in November 2005, and was working in a subsidiary of an Israeli parent company (her previous employer). Her family joined her there in January 2006, her husband having resigned from his job in Israel. Their house in Israel was rented out, their cars were sold and they managed all the financial activities in Hong Kong. Yael expected to work in Hong Kong for at least 5 years or more, but her employment was terminated by her employer less than 3 years after she began work there, so she had no choice but to return to Israel.

During all these years, the salaries were paid by the parent company in Israel treating her as an 'Israeli resident' for tax purposes. In addition, she was required to pay taxes on her income in Hong Kong, which were deducted from her pay slip.

Contention of the taxpayer

Yael claimed that she does not have to pay taxes in Israel and also filed for a refund of the withholding taxes deducted in Israel by the parent company, because in her opinion she was not an 'Israeli resident' during the period she lived and worked in Hong Kong.

She further claimed that as she was not a resident of Israel in those years, the income earned from work abroad would not be taxable in Israel.

Contentions of the Tax Assessor

The Israel Tax Authorities (ITA) did not agree with Yael's contentions: she was considered an 'Israeli resident' in the relevant tax years, 2006–7, as she did not comply with the conditions related to 'permanent Israeli resident termination'.

The ITA claimed that there are some objective indicators to demonstrate that her centre of life and economic interests is in Israel:

- Yael and her husband owned a house in Israel, which they did not sell
- They still have a bank account in Israel
- They have activity pension plans through insurance companies in Israel
- They took holidays in Israel
- Moreover, as a taxpayer Yael received her salaries from a parent company in Israel, which considered her as an 'Israeli resident' who worked abroad but not as someone who had changed her place of residence by relocating.

Therefore, the Tax Assessor decided that she is an 'Israeli resident' who has Israeli taxable income.

Decision of District Court (First Tier Tribunal)

The Israeli District Court did not accept the tax assessor's contentions and held the following:

'Presumption of number of days': In the first tax year (2006), when the taxpayer left for Hong Kong, she stayed in Israel for only 42 days, meaning that she did not fulfil the test of 'total staying period'; therefore it is possible to contradict the above presumption and possible to hold that the 'taxpayer's centre of life place' was not in Israel.

'Taxpayer's centre of life place': According to the District Court's ruling, there are objective indicators proving the affinity to Hong Kong (rather than Israel):

- The active bank accounts were managed at Hong Kong
- Her family left Israel to live with her in Hong Kong
- Her husband resigned from his job in Israel
- The children studied at Hong Kong schools
- The couple sold their cars in Israel
- Their medical insurance was based in Hong Kong.

The District Court held that even if the taxpayer left properties such as real estate and bank accounts, it

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doesn't mean that her centre of life place has not been changed. Moreover, the law refers to a 'permanent house': in this case, the house was not used as the taxpayer's residence, so cannot be considered her 'permanent house'.

Even the *subjective indicators* reinforce the assumption that the centre of life place changed for the taxpayer:

- She was expected to live and work in Hong Kong for long periods, and testified that she wanted to change her centre of life place to Hong Kong for some years
- Her husband left his job – this behaviour also indicates an intention to change centre of life place for a prolonged period
- The parents admitted their children to schools in Hong Kong
- They rented out their house in Israel for a long period of time
- They have social connections in Hong Kong.

Salary payments by the parent company: The District Court held that this argument is not enough to change the conclusion about change of residency. The taxpayer resisted this process and requested to pay these salaries by a Hong Kong company.

Returning to Israel: In this case, the taxpayer had no choice but to return to Israel. This does not mean that her leaving for Hong Kong was temporary, nor that her intention was to remain in Israel and keep Israel as her 'centre of life place'.

The result is that the District Court accepted the appeal and ordered to cancel the tax assessments that had been imposed on the taxpayer.

EDITORIAL COMMENT

The determination of residential status is often debatable, but the facts in the instant case were heavily favouring the taxpayer. The decision of the Court is thus correct and would provide clarity in interpretation of the law on determination of residential status.

Flag Telecom Group Ltd v. DCIT Circle-2(1), Mumbai [2015] 54 taxmann.com 154 (Mumbai-Trib.)

Contributed by Surbhi Goyal, S.C. Vasudeva & Co.

The Hon'ble Tribunal in the said case held that the consideration received by a foreign company from an Indian Company for sale of capacity involving transfer of ownership of telecom cable link to Indian Company is not taxable as 'Royalty' under Section 9(1)(vi) of the Income Tax Act, 1961 as it is distinguished from a mere payment for simply user of capacity.

Facts of the case

Flag Telecom Group Ltd ('the assessee') is a company incorporated in Bermuda, from where it is managed and controlled. Since India has no tax treaty with Bermuda, the provisions of the Income Tax Act were applicable to the assessee.

The assessee was set up to build a fibre-optic cable system to increase telecommunication traffic among Western Europe, Middle East, South Asia, South East Asia and the Far East.

The assessee had entered into a Memorandum of Understanding (MOU) with 13 parties for the purpose of planning and implementation of the said fibre-optic cable system. Videsh Sanchar Nigam Ltd (VSNL) was one of the original party to the MOU.

On 31 March 1995, a Cable Sales Agreement (CSA) was entered into by the assessee and VSNL, which was further amended on 29 April 1998, by which VSNL had bought the capacity in the cable system for US$ 28.94 million. The CSA provided for the ownership rights in the Flag cable system with all the rights and obligations in the capacity sold. The entire procedure for ownership of capacity in the cable system and all other terms and conditions are contained in a separate agreement, titled Construction and Maintenance Agreement (C&MA), which was for a period of 25 years and coincided with the life of the cable. Once C&MA comes into force, the CSA would come to an end.

The Assessing Officer (AO) taxed the entire payment made by VSNL to the assessee for US$ 28.94 million in India under Sections 9(1)(vi) and 9(1)(vii), considering it as royalty/fee for technical know-how. The AO also taxed the income from standby maintenance activities of US$ 512,955, which was separately received by the assessee, under the head fee for technical services (FTS) within the meaning of Section 9(1)(vii) of the Act.

The assessee appealed to the Commissioner of Income Tax (Appeals) [CIT(A)], who held that:

- The payment of US$ 28.94 million received by the assessee is towards sale of capacity, which is taxable as business income in India under Section 9(1)(i); it cannot be taxed as royalty or FTS under Sections 9(1)(vi) and 9(1)(vii)
- The income that can be said to be attributable in India is to be worked out on the basis of proportionate worldwide profit
- The payment received on account of standby maintenance in terms of C&MA is taxable in India as FTS under Section 9(1)(vii).

Contention of the Assessee

The payment received towards sale of capacity cannot be considered to be royalty as the cable system is not a patent, invention, model, design, secret formula, process, trademark or similar property. The assessee is not imparting any information concerning any knowledge, experience or skill, nor is there any transfer of any right in respect of any copyright, literary, artistic or scientific. Also, the C&MA provides that VSNL has all the ownership rights and obligations in respect of the capacity in the cable system and in case of a 'royalty' agreement, the complete ownership is never transferred. Therefore, the income received is purely in the nature of business income from sale of goods – in this case, capacity in the cable.

Further, the assessee contended that the above income is not taxable in India since the income from sale of capacity in the cable system does not arise through or from any business connection in India. In support of his contention, reliance was placed upon Circular No. 23 dated 23 July 1969, issued by the Central Board of Direct Taxes, wherein it has been clarified that the income of a non-resident is not taxable provided the

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contract to sell is made outside India and the sale is on a principal-to-principal basis.

Alternatively, if such income has to be taxed in India, then the attributable revenue should be determined based on the length of the cable situated in India vis-à-vis length of the cable worldwide.

Regarding standby maintenance charges, the assessee contended that such charges are merely for setting up conditions for the efficient rendering of technical services and not for providing any services. The fixed cost on standby maintenance cannot be said to be a FTS, but business income, which for the reasons mentioned above cannot be taxed in India. If actual maintenance is being carried out, the same is charged from VSNL and offered for tax as FTS in India.

Contention of the Revenue

The revenue contended that the payment made by VSNL in respect of 'capacity' is in the nature of royalty or FTS, and is therefore taxable under Sections 9(1)(vi) and 9(1)(vii).

This is evident from the fact that the cable network, the landing equipment and the segment capacity are part of one commercial asset owned by the assessee, and it is only the different segments on notional basis that have been given user rights to different parties and there is no sale/delivery of capacity to the buyers.

Once the 'equipment' or 'process' is made available to the user on payment of fees and such process is used according to the customer's needs, there is 'use' of such process irrespective of the fact that such equipment or process is not directly under physical control of the user; hence mere economic interest in commercial equipment with right to use is enough to take such payment as 'royalty' under Section 9(1)(vi).

Decision of the Tribunal

The entire agreement was for the period of 25 years, which coincided with the life of the cable. The agreement included clear-cut clauses for ownership: one such clause clearly envisaged that the net proceeds on disposition of the cable system would be shared among the signatories in proportion to their ownership rights. Furthermore, there was right to assign the capacity, borne out by the fact that the purchaser of the capacity could sell or grant right to use the capacity in the cable system to some other party.

All this clearly indicated that the signatory would become the owner of the capacity in the cable system after the purchase – that is, VSNL in the instant case.

This fact further establishes that there was no payment for simply user of the capacity. In case of a royalty agreement, complete ownership is never transferred to the other party. What is envisaged in Section 9(1)(vi), read with the explanation thereto, is that there should be transfer of rights of any kind of the property as defined therein; or imparting of any information in respect of various kinds of property; or use of rights to use of any equipment, etc.

If the consideration was received for transferring the ownership with all rights and obligations, then such a consideration could not be taxed as royalty.

Further, the source of income must lie in India so as to be deemed to be income in India. The source must flow from an asset; but in this case there is no asset belonging to the assessee through or from which the assessee derives income. Therefore, no income has accrued or arisen in India within the deeming provision of Section 9(1)(i), as the sale has been concluded outside India on a principal-to-principal basis.

Also, there would be no attribution of income on a proportionate basis as per explanation 1(a) to Section 9(1)(i), since no income has accrued or arisen to the assessee within the deeming provision of Section 9(1)(i). Thus, payment of US$ 28.94 million received by the assessee from sale of capacity to VSNL is not taxable either as 'royalty' under Section 9(1)(vi) or as 'business income' accruing or arising in India within the deeming provision of Section 9(1)(i).

On the issue of 'standby maintenance charges', it was held that such receipts from VSNL cannot be taxed as FTS under Section 9(1)(vii) as there was no rendering of services. However, any payment received on account of actual repair or maintenance would definitely fall within the ambit of FTS chargeable to tax under Section 9(1)(vii).

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EDITORIAL COMMENT

There is a distinction between a payment made for outright purchase and payment made for usage of rights. In the former case, the amount is taxable as business profits; in the latter, it is taxed as royalty. This distinction has been correctly applied by the Tribunal to the facts of the case.

Morison International

The Next Step

Contact Morison International to discuss your needs

www.morisoninternational.com

Morison International
193 Praed Street
Paddington
London, W2 1RH
United Kingdom

T: +44(0)20 7638 4005
E: info@morisoninternational.com