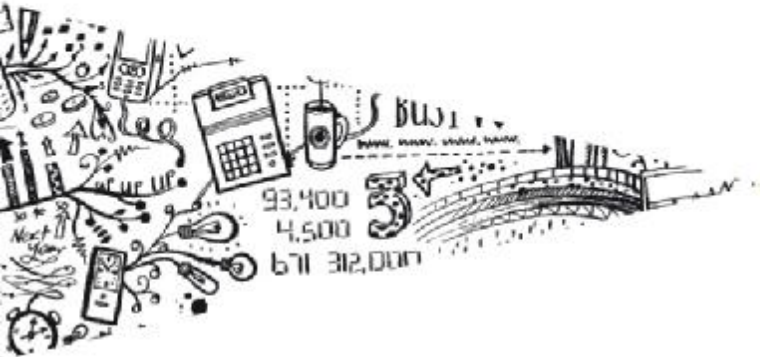


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EY Tax Alert

Delhi HC ruling on 'business connection' and tax treatment of payments for software bundled with hardware



Executive summary

This Tax Alert summarizes a recent ruling of the Delhi High Court (HC) ^[1] in the case of Ericsson Radio Systems A.B. (Taxpayer). The two main issues were (i) whether sale of telecommunication equipment to cellular operators in India constituted a business connection under the provisions of the Indian Tax Laws (ITL) and (ii) whether payments received for software that was sold as part of the telecommunication equipment is taxable as royalty under the ITL and the India-Sweden Double Taxation Avoidance Agreement (Sweden DTAA). On the first issue, the HC ruled that as the sale of the telecommunication equipment took place outside India and title in goods also passed outside India, the Taxpayer did not have a business connection in India. On the second issue, the HC ruled that the consideration paid by the cellular operators can be treated as royalty only if the cellular operators had obtained all or any of the copyright rights in such software that is protected in India as a literary work. A distinction also needs to be made between acquisition of a 'copyright right' and a 'copyrighted article'. In the present case, the software was embodied in the telecommunication equipment that was supplied and software could not be used independently. Hence, as the software merely facilitated the functioning of the telecommunication equipment and formed an integral part of it, no part of the payment could be classified as payment towards royalty.

^[1] [ITA No. 504/2007, 507/2007, 508/2007, 511/2007 and 397/2007]

Background and facts

- ▶ Under the ITL, a non-resident (NR) is taxable in India if income is either received in India or accrues or arises in India or is deemed to accrue or arise in India. The ITL, furthermore, defines the circumstances in which income is deemed to accrue or arise in India in the hands of an NR. The categories of deemed accrual cover, *inter alia*, income accruing directly or indirectly through or from any 'business connection' in India. However, taxation on account of business connection is restricted to profit attributable to business operations carried out in India.
- ▶ 'Royalty' is defined in the ITL to mean consideration for the transfer of all or any rights (including the granting of a license) in respect of any copyright. The comparable definition under the Sweden DTAA defines 'royalty' to mean consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work.
- ▶ The Taxpayer was incorporated in Sweden and was a wholly owned subsidiary of Telefonaktiebolaget L.M. Ericsson. The main business of the Taxpayer is the supply of hardware and software which is used in the business of rendering telecommunication services, and for this purpose, it undertakes projects of supply of the telecommunication equipment on a turnkey basis. In telecommunication projects, the activities involved are supply of hardware and embedded software, installation and commissioning of the telecommunication equipment and its after-sales service.
- ▶ During the year under consideration, the Taxpayer entered into contracts with 10 cellular operators in India for supply of hardware and software (equipment) for which installation and testing in India was done by its group entities.
- ▶ Ericsson Telephone Corporation India AB (EFC), another Swedish company and the Taxpayer's group entity, had a branch in India. Ericsson Communications Ltd. (ECL), an Indian entity, was another company belonging to the same group. These entities were in the business of installation of the equipment and provided marketing support to the Taxpayer. During the year under consideration, for the first three months, the work of installation and marketing support was carried out by EFC, and for the remaining nine months, the same work was assigned to ECL, the Indian associate. The incomes of these entities were separately offered to tax in India.
- ▶ As per the terms of the supply contract between the Taxpayer and the cellular operators, the equipment supplied was not to be accepted till it passed an Acceptance Test, which was carried out in India.
- ▶ The Tax Authority passed an order in which it held that the Taxpayer had a business connection in India and its income was, accordingly, held as taxable in India. Further, it held that as the Taxpayer had provided software to the cellular operators under a license, the part of consideration specified separately in respect of

software was taxable as royalty as per the provisions of the ITL as well as the Sweden DTAA.

- ▶ On appeal, the First Appellate Authority granted partial relief to the Taxpayer. On second appeal before the Delhi Tribunal (Tribunal), the matter was referred to the Special Bench of the Tribunal. The Special Bench held that the activities of the Taxpayer did not constitute a business connection in India under the ITL and also that the payment could not be characterized as royalty either under the ITL or the Sweden DTAA. Aggrieved by the order of the Special Bench, the Tax Authority filed an appeal with the HC.

Tax Authority's contentions

- ▶ Whether or not the right to receive the money has arisen in India would depend on where the contract was entered into and the place where the contract had to be performed (i.e., the place where a given right could be exercised). In the present case, these rights were granted/exercised in India.
- ▶ It was not disputed that all the customers were based in India, the equipment supplied were set up in India, the hardware was supplied for setting up of a system in India, the Acceptance Test to confirm that the installation was successfully carried out in India and the responsibility to ensure successful installation in India vested with the Taxpayer.

- ▶ The Taxpayer's obligations did not end with the passing of the title to the cellular operator, but, in addition, valuable rights were granted to the customers which could only be exercised in India and, hence, this was not a case of mere sale of goods transaction and, thus, the Tax Authority was right in its assessment of the Taxpayer.
- ▶ The software part of the equipment supply is taxable as royalty since copyright in the software still vested with the Taxpayer and payments made were only for the license to use the software. The fact that license to use software was provided was made clear in the contracts. This transaction is a 'royalty' receipt both under the ITL as well as the Sweden DTAA.
- ▶ The reference to the OECD Commentary was not relevant as it could not be used to interpret the scope of the relevant provisions of the Sweden DTAA.

Taxpayer's contentions

- ▶ The Taxpayer was an NR and could be subjected to tax only on income which was covered by the ITL. The income from the supply of equipment accrues outside India as the equipment was supplied outside India. The place of execution of the contract was not relevant. Reliance was placed on the Supreme Court (SC) decision in the case of Ishikawajima-Harima Heavy Industries Ltd (Ishikawajima)^[2] where it was held that the fact

^[2] [288 ITR 408]

that the contract was signed in India was of no material consequence since all activities in connection with the offshore supply were carried on outside India.

- ▶ The title to the equipment as well as risks associated therein passed on to the buyers in Sweden. In terms of provisions of the Sale of Goods Act (SOGA), the property in goods passes when the parties intend to pass it. In the present case, the intention of the parties was manifested in the supply contracts and the provisions relating to the Acceptance Test in India did not affect such an intention.
- ▶ The software was not supplied separately, but was integrated with the hardware. Hence, the question of royalty payment does not arise. Separate break-up of software price in the contract was on account of differential custom duty and did not dilute the fact that software was integrated with hardware and had no independent use. Even otherwise the distinction between 'copyright' and 'copyrighted article' as recognized by the Special Bench is correct. This was, at best, a sale of copyrighted article since the cellular operators did not obtain any rights in the copyright.

Ruling of the HC

On business connection

- ▶ Supplies pursuant to the supply contract were made overseas. The property in goods had passed on to the buyer outside India.

- ▶ The terms of the contracts made it clear that the Acceptance Test was not a material event for passing of the title and risks in the supplied equipment. This was due to the reason that even if such test showed that the system did not conform to the contractive parameters, the only consequence was that the cellular operators were entitled to call upon the Taxpayer to cure the defect by repairing or replacing the defective part. If there was a delay on account of non-compliance of the Acceptance Test, the contracts provided for damages. Thus, the taxable event took place outside India with the passing of the property from seller to the cellular operators and the conduct of the Acceptance Test in India did not impact this conclusion. In terms of SOGA, the property in goods passes as intended by the parties. The clear intention, as manifested in the contracts, was to pass the property outside India.
 - ▶ The places of negotiation, signing of the contracts, formal acceptance or overall responsibility of the Taxpayer were not relevant considerations in the present fact pattern. Since the transaction related to sale of goods, the relevant factor was where the property in the goods had passed. In the present case, the finding was that property had passed on the high seas outside India. The goods were manufactured outside India and even the sale took place outside India. Once this fact was established, even in those cases where it was one composite contract (though it was not found to be so in the present case), supply had to be segregated from the installation and only thereafter the profits needed apportionment. As per the language of the ITL, income is taxable in India only to the extent it relates to operations carried out in India. The SC decision in case of Ishikawajima was considered applicable to the facts in the present case.
 - ▶ The installation contract was between EFC/ECL and the cellular operators. There was no contract between the Taxpayer and EFC/ECL. Accordingly, no profit arose for the Taxpayer from the installation contract. A business connection would not arise between the Taxpayer and EFC/ECL merely because EFC/ECL is a subsidiary of the Taxpayer's holding company.
 - ▶ Hence, the Taxpayer did not have any business connection in India. Also, the Taxpayer has not earned any income in India through or from any business connection. Accordingly, it was not necessary to go into the issue whether the Taxpayer had any permanent establishment in India under the Sweden DTAA.
- On whether the receipt for software loaded in the hardware is royalty***
- ▶ The software supply was an integral part of the supplied equipment and was used by the cellular operators for providing the cellular services to its customers. The software was embodied in the equipment and the Tax Authority accepted that it could not be used independently. The software merely facilitates the functioning of the equipment and was an integral part thereof. Hence, it was not permissible for the Tax Authority to assess the hardware and software separately.
 - ▶ The supply contract could not be separated into two viz., hardware and software^[3]. In the present case, the lump sum price paid as per the terms of the supply contract was bifurcated into consideration for the supply of the equipment and software only because differential customs duty was payable.
 - ▶ The Taxpayer supplied the software which was incorporated on a CD, it had supplied tangible property and the payments made by the cellular operators for acquiring such property could not be regarded as payments by way of royalty.
 - ▶ To qualify as royalty under the ITL, it was necessary to establish that there was transfer of all or any rights (including the granting of any license) in respect of copyright of a literary, artistic or scientific work. The Copyright Act makes it clear that a computer program was to be regarded as a 'literary work'. Thus, in order to treat the consideration paid by the cellular operators as royalty, it was to be established that the cellular operators, by making such payments, obtain all or any of the copyright rights of such literary work. This had not been established in the present case.
 - ▶ A distinction had to be made between the acquisition of a 'copyright right' and a 'copyrighted article'. This distinction has been accepted in the Authority for Advance Rulings in

[3] Reliance was placed on the judgment of the SC in the case of Sundwiger EMFG Co [266 ITR 110]

the case of Dassault Systems K. K.^[4]. The submission made by the Taxpayer on the basis of the commentary to the OECD Model Convention is correct.

- ▶ Even assuming the payment is royalty under the ITL, it can never be regarded as royalty under the Sweden DTAA as the definition in the Sweden DTAA is narrower than the definition in the ITL. Royalty under the Sweden DTAA contemplates payment that is dependent upon use of the copyright and not a lump sum payment as is the position in the present case.
- ▶ The payment received by the Taxpayer was towards the title of the equipment of which software was an inseparable part incapable of independent use and it was a contract for supply of goods. Therefore, no part of the payment could be classified as payment towards royalty.

Comments

The present ruling elucidates the concept of 'business connection' under the ITL. It reiterates that an NR earning income in India can be taxed only to the extent of operations carried out in India. This ruling should be helpful for taxpayers in applying the concept of 'business connection' in relation to transactions of offshore supply which needs to be installed in India.

The characterization of computer software transactions has been a contentious issue with the

^[4] Please refer Ernst & Young Tax Alert dated 2 February 2010

Indian Tax Authority over the last several years. The dispute has principally focused on whether such transactions should be characterized as 'royalty' or as 'business profits/sales income'. While the Tax Authority is of the view that such payments should be classified as 'royalty', regardless of the nature and extent of rights granted to the end user or the purpose for which the end user uses the software, the taxpayers had generally taken a view that where an end user does not obtain rights that enable commercial exploitation of the intellectual property in the computer software, the transaction should be classified as generating 'business profits'.

The Taxpayer's position was largely based on the OECD Commentary and was supported by a number of decisions of the Income Tax Appellate Tribunal, including that of a Special Bench. The OECD Commentary and the Special Bench had recognized the distinction between a right in the copyright and a copyrighted article. However, in a recent decision, the Karnataka High Court, in a batch of appeals, with the lead case being Samsung Electronics Co. Ltd.^[5] and in the case of Lucent Technologies^[6] had taken a divergent view. The Delhi HC, in this decision, having upheld the decision of the Special Bench on this issue, should help reinforce the taxpayers' position on this contentious issue.

^[5] Please refer Ernst & Young Tax Alert dated 30 November 2011

^[6] Please refer Ernst & Young Tax Alert dated 19 December 2011

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