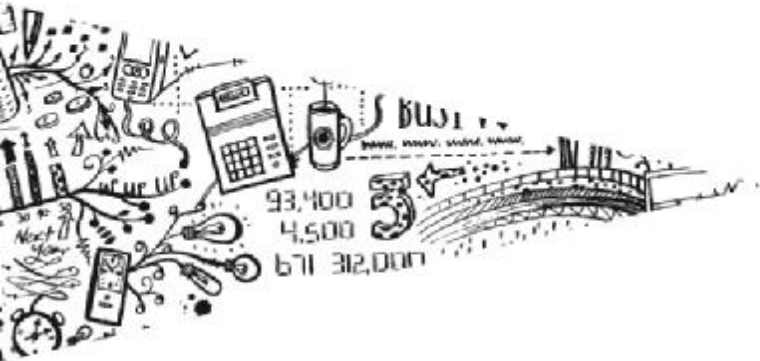


19 May 2011

EY Tax Alert

Mumbai ITAT rules charges for data processing not 'royalty'



Executive summary

This Tax Alert summarizes the recent ruling of the Mumbai Income Tax Appellate Tribunal (ITAT) in the case of Standard Chartered Bank (Taxpayer) (ITA No. 3827/ MUM/ 2006) on the issue whether data processing charges paid by the Taxpayer would constitute 'royalty' under the Indian Tax Laws (ITL) and the India - Singapore Tax Treaty (Tax Treaty). It was held that the payments were made for use of a facility and not any process. Furthermore, in the absence of control or physical access to any equipment, it cannot be said that the payment was made for any use or right to use the equipment. Hence, payment would not amount to 'royalty' under the ITL and the Tax Treaty and would be business income not chargeable to tax in absence of PE.

Facts

- ▶ The Taxpayer, a non resident company, was engaged in the business of banking in India through various branches. It entered into an agreement with SPL, a Singapore company, for providing data processing support from outside India to the Taxpayer for its business in India (Agreement). The Agreement required SPL to make available disc storage capacity in its Data Centre at Singapore for the Taxpayer's exclusive use.
- ▶ Before the Tax Authority, the Taxpayer submitted the following details about the nature of services:

- ▶ Raw input bank transaction data is transmitted in electronic form to SPL for processing.
 - ▶ Processing is done by SPL at Singapore as per the Taxpayer's requirement, using hardware and software (through human intervention), whenever required.
 - ▶ The operating software of SPL's mainframe computer was developed by third party vendors and licensed to SPL.
 - ▶ Processed data is electronically transmitted back to India in the form of reports as per the Taxpayer's specifications.
 - ▶ SPL keeps a back up of the data and makes it available to the Taxpayer on request.
- ▶ The Taxpayer claimed that charges paid by it to SPL do not amount to royalty under the ITL as well as the Tax Treaty. Since SPL did not have a permanent establishment (PE) in India, the payments would be in the nature of business profits in the hands of SPL and not taxable in India under the Tax Treaty.

In view of the above, the Taxpayer filed an application for 'nil' withholding of taxes before the Tax Authority. The Tax Authority held that the payment constituted 'royalty' under the ITL as well as the Tax Treaty. On appeal, the first appellant authority upheld the Tax Authority's order and concluded that the payments were made for (a) use of a 'process' provided by SPL through its computer facility for data processing (b) use of 'scientific equipment' since the arrangement was for renting out disc space in the hardware system and the Taxpayer exercised a constructive control over the infrastructure facilities created for its exclusive use.

- ▶ Aggrieved by the above, the Taxpayer preferred an appeal before the ITAT.

Issue for consideration

Whether data processing charges paid by the Taxpayer amounts to 'royalty' and, thereby, subject to withholding of taxes under the ITL or the Tax Treaty.

Taxpayer's contentions

- ▶ Based on the Agreement and submissions made about the nature of services, the charges were paid for data processing and not for use of any process or equipment.
- ▶ The Taxpayer provided all the software used in processing of data by SPL in Singapore. Furthermore, the Taxpayer did not acquire any rights to the operating system software of the mainframe computer used by SPL. Even SPL had only a license for use of the operating software for performing services and was not the owner of it.
- ▶ There was no right granted to the Taxpayer to access or use the mainframe computer used by SPL. Reliance was placed on the decision of the Delhi High Court (HC) in the case of Asia Satellite Telecommunications [332 ITR 340] wherein it was held that payments were not 'royalty' as the ultimate control on the process and equipment were not with the payer.

- ▶ Support was also drawn from various judicial precedents^[1] where it was held that the payments would not amount to royalty where the payer did not exercise any possessory rights in relation to the equipment and it only availed services provided by the owner of the entire network, related equipments and facilities.

Tax Authority's contentions

- ▶ SPL has provided a process by providing its computer facility to process raw data provided by the Taxpayer. There is no requirement under the definition of 'royalty' under the ITL for the provider to be the owner of the process.
- ▶ The payment was made for the purpose of availing CPU and disc capacity. Though the Taxpayer did not have physical possession, it exercised constructive control over the facility since it was utilized exclusively for the Taxpayer.
- ▶ Reference was also made to the India's positions to the OECD commentaries regarding use and right to use scientific equipments in the context of royalty.

ITAT's ruling

Use or right to use any 'process'

- ▶ There is no use or right to use any process of SPL by the Taxpayer at any of the stages i.e. transmission of raw data, processing of data by SPL staff and electronic transmission of duly processed output data.
- ▶ The payment is for a facility which is available to any person willing to use the facility as laid down by the Madras HC in the case of Skycell Communications Ltd. v DCIT [251 ITR 53].
- ▶ The consideration paid by the Taxpayer cannot be said to be for the software embedded in the mainframe computer of SPL as SPL is only a licensee of the software. Furthermore, the Taxpayer could only receive back the data processed without having any access to the mainframe computer and, hence, there was no use or right to use any 'process'.
- ▶ Mumbai ITAT decision in case of Kotak Mahindra Primus Ltd. v. DCIT [*supra*] squarely applies to the present facts. It was held therein that payments made for specialized data processing of raw data using mainframe computers located abroad is not liable to tax as royalty since there was no control over the actual processing of data and there was no physical access or control over the mainframe computer.

Use or right to use any 'equipment'

- ▶ Reliance was placed on the judicial precedents^[2] quoted by the Taxpayer, for the meaning of 'use' or 'right to use'. It was observed that:
 - ▶ Earmarking a space segment capacity of the equipment does not result in possession (actual or constructive) of the equipment.
 - ▶ The context and collocation of the two expressions 'use' and 'right to use' followed by the word 'equipment' indicated that there must be some positive act of utilization, application or employment of equipment for the desired purpose.
 - ▶ If an advantage was taken from sophisticated equipment installed and provided by another, it could not be said that the recipient/customer used the equipment as such.
 - ▶ What was contemplated by the word 'use' in the ITL was that the customer came face to face with the equipment, operated it or controlled its functions in some manner. Mere use of the facility created by the service provider, which was the owner of the entire network and related equipment, is not included.
- ▶ The Technical Advisory Group of the OECD had brought out certain tests (as below) which could render the transaction to be that for use of equipment:
 - ▶ Customer is in physical possession or control or significant economic/ possessory interest in the property

^[1] Dell International Services [305 ITR 37]; ISRO Satellite Centre [307 ITR 59], Kotak Mahindra Primus Ltd. v DCIT [105 TTJ 578]

^[2] Dell International Services ; ISRO Satellite Centre; Kotak Mahindra Primus Ltd. v DCIT (*supra*)

- ▶ Risk of substantially diminished receipts or increased expenditure on account of non-performance under the contract is not borne by the provider
- ▶ Property not concurrently used to provide significant services to entities unrelated to the customer
- ▶ The total payment does not substantially exceed the rental value of the equipments for the contract period.

It has also expressly clarified that the data warehousing services would not give rise to user of equipment.

The Taxpayer took advantage of a facility of sophisticated equipment installed and provided by SPL. There is nothing to show positive act of utilization, application or employment of equipment by the Taxpayer for the desired purpose. Therefore, it cannot be said that the payment is royalty under the ITL and the Tax Treaty.

Comments

This ruling of the ITAT upholds the principle that payments would constitute 'royalty' only if there is clear use or right to use of equipment/process and not merely making use of a facility provided by a vendor without exercising any control over it. It emphasizes on factors like interface/control and is in line with the position generally adopted by taxpayers and with recent decisions on similar issues. The ruling also provides general guidance on interpretation of the royalty definition in the ITL and specifically with relation to use or right to use equipment.

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near CN Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru

"UB City", Canberra Block
12th & 13th floor
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
+ 91 80 2224 0695 (13th floor)

Chennai

TPL House, 2nd floor
No. 3 Cenotaph Road Teynampet
Chennai - 600 018
Tel: + 91 44 6632 8400
Fax: + 91 44 2431 1450

Hyderabad

205, 2nd floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad - 500 003
Tel: + 91 40 6627 4000
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre
Hitech City, Madhapur
Hyderabad - 500081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kolkata

22 Camac Street
Block 'C', 3rd floor
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai

14th floor, The Ruby
Senapati Bapat Marg, Dadar
Mumbai - 400 028
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000
6th Floor, Express Towers,
Nariman Point,
Mumbai - 400 021
Tel: + 91 22 6657 9200
Fax: + 91 22 2287 6401

Block B-2, 5th Floor
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063, India
Tel: + 91 22 6749 8000
Fax: + 91 22 6749 8200

NCR

Golf View Corporate Tower B
Near DLF Golf Course Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,
Sector 126, NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune

C-401, 4th floor Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

Ernst & Young Pvt. Ltd.

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit

www.ey.com/india

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Ernst & Young Private Limited is one of the Indian client serving member firms of Ernst & Young Global Limited.

Ernst & Young Pvt. Ltd is a company registered under the Companies Act, 1956 having its registered office at 22, Camac Street, Block C, 3rd Floor, Kolkata- 700016

© 2011 Ernst & Young Pvt. Ltd.
All Rights Reserved.

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young Pvt. Ltd. accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.