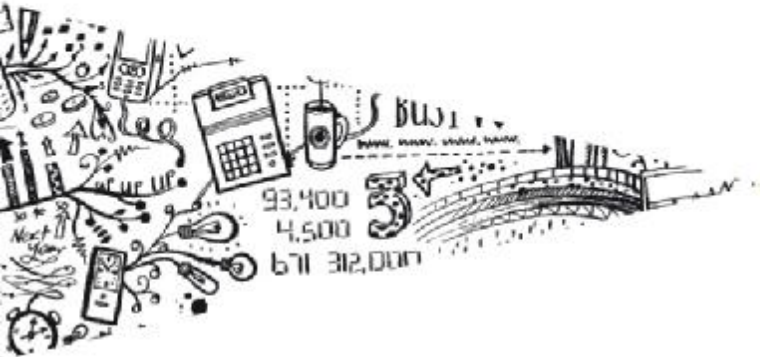


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EY Tax Alert

Mumbai ITAT rules that accreditation fees do not constitute 'royalty'



Executive summary

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (ITAT) in the case of Anchor Health and Beauty Care Pvt. Ltd. (Taxpayer) [ITA No. 7164/MUM/08]^[1] on the issue of whether taxes are required to be withheld, under the provisions of the Indian Tax Laws (ITL), on accreditation fees paid to a non-resident (NR) and whether such fees are taxable in India as 'royalty', either in terms of the ITL or in terms of the India-UK Double Taxation Avoidance Agreement (DTAA). The ITAT held that an accreditation provides certain comfort levels to the end users of the products which may constitute a unique selling proposition (USP) and which may also be used for the purposes of marketing of the products. However, this, by itself, cannot fall within the ambit of 'royalty' for the reason that such payment is not envisaged to fall within the definition under the DTAA. As the payment is not taxable in India, no taxes are required to be withheld.

Background and facts

- ▶ The Taxpayer, a tax resident of India, was engaged in the business of manufacturing and trading of tooth powder/paste/brush and other health care products.
- ▶ The Taxpayer paid certain amount to British Dental Health Foundation (BDHF), a UK-based registered charitable institution, towards

accreditation fees. BDHF was established, inter alia, to evaluate consumer oral health care products to ensure that the products are clinically proven and are not exaggerated. Furthermore, an independent panel of internationally recognized dental experts studies all the claims carefully to ensure that the statements provided are true and backed by reliable scientific evidence. As a result of the accreditation granted by BDHF, the Taxpayer was allowed to use the approval of BDHF while marketing its products.

- ▶ The Taxpayer was under a bona fide belief that accreditation fees paid were not taxable in India and, consequently, no taxes were required to be withheld under the provisions of the ITL. However, the Tax Authority rejected the Taxpayer's claim and held that the withholding tax provisions are attracted on payments made to BDHF. Furthermore, in the absence of a specific certificate obtained from the Tax Authority on non-taxability, the Taxpayer was required to withhold appropriate taxes. As a consequence of non-withholding taxes, the entire payment claimed as an expense against taxable income was not allowable while computing the Taxpayer's income.
- ▶ Aggrieved by the order of the Tax Authority, the Taxpayer appealed before the First Appellate Authority. The First Appellate Authority noted the fact that BDHF did not have a permanent establishment (PE) in India in terms of Article 5 of the DTAA. Furthermore, the First Appellate Authority was also of the view that the payment cannot be characterized as 'royalty' under Article 13 of the DTAA. Therefore, the payment was not

taxable in India. Consequently, no taxes were required to be withheld under the provisions of the ITL and, thus, disallowance of the expense was unwarranted.

- ▶ Aggrieved by the First Appellate Authority's order, the Tax Authority appealed before the ITAT. The Tax Authority's claim was that the Taxpayer derived valuable advantage from the said accreditation and the same was also used as a marketing tool and, consequently, the same should be characterized as 'royalty' under Article 13 of the DTAA.

ITAT's ruling

- ▶ The scope of the expression 'royalty', as defined under Article 13 of the DTAA, is restricted when compared to the definition under the ITL. Clause (b) of the definition deals with 'equipment leasing' and is, therefore, not applicable to the present case. Furthermore, Clause (a) also does not deal with a situation in which payment is made for accreditation to a UK resident for use in India for the purpose of promoting sales.
- ▶ The accreditation carried out by BDHF does not permit the accredited product to use or give it the right to use a trademark or information concerning industrial, commercial or scientific experience etc. An accreditation by a reputed body may give certain comfort levels to the end users of the products and, thus, may constitute a USP and, hence, may also be used for the

^[1] Source: <http://www.itatonline.org>

purposes of marketing of the products. However, the payment to BDHF for accreditation cannot be characterized as 'royalty' as it is not for the right to use its name for marketing. 'Royalty' has been exhaustively defined under Article 13 of the DTAA and unless the payment fits into the description of the definition, it cannot be termed as 'royalty'.

- ▶ When the payment falls outside the definition of 'royalty', it is impermissible to look at normal connotations of the expression used in business parlance. Merely because the Taxpayer is benefited by the accreditation and has used the same for its marketing purposes, the payment cannot be characterized as 'royalty'.
- ▶ The payment is in the nature of 'business profits' and is not taxable in the absence of a PE in India.
- ▶ In terms of the Supreme Court decision in the case of GE India Technology Centre Pvt. Ltd.^[2], appropriate taxes are required to be withheld from payments to NRs only if the payment is chargeable to tax in India in the hands of the NRs. The underlying principle is that the tax withholding liability of the payee is a vicarious liability and is discharged on behalf of the recipient. When the recipient does not have the primary liability to be taxable in respect of income embedded in the receipt, the vicarious liability of the payer does not survive. Furthermore, if a

specific order from the Tax Authority with respect to non-chargeability is not obtained, it is not, in itself, a justification for the Tax Authority to proceed on the basis that the payer had an obligation to withhold tax. The Tax Authority is still under an obligation to demonstrate and establish that the NR has a tax liability in respect of the income embedded in the payment.

- ▶ As the payment is not taxable in India, either as 'royalty' (as the same does not fit into the definition under Article 13 of the DTAA) or as 'business profits' (in the absence of a PE in India), no tax is required to be withheld by the Taxpayer.

Comments

This ruling clarifies that merely obtaining accreditation for a product, which in turn is used as a marketing tool, cannot fall within the ambit of 'royalty' as defined under the DTAA. Furthermore, the ITAT clarifies that the withholding obligation cannot be invoked on a payer unless the primary tax liability of the NR is established and that the Tax Authority is still under an obligation to demonstrate and establish that the NR has a tax liability in respect of the income embedded in the payment.

^[2] [327 ITR 456]

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