ASSOCHAM

3rd International Tax Conference

"Recent Indian case laws / rulings on International Tax / Treaties"

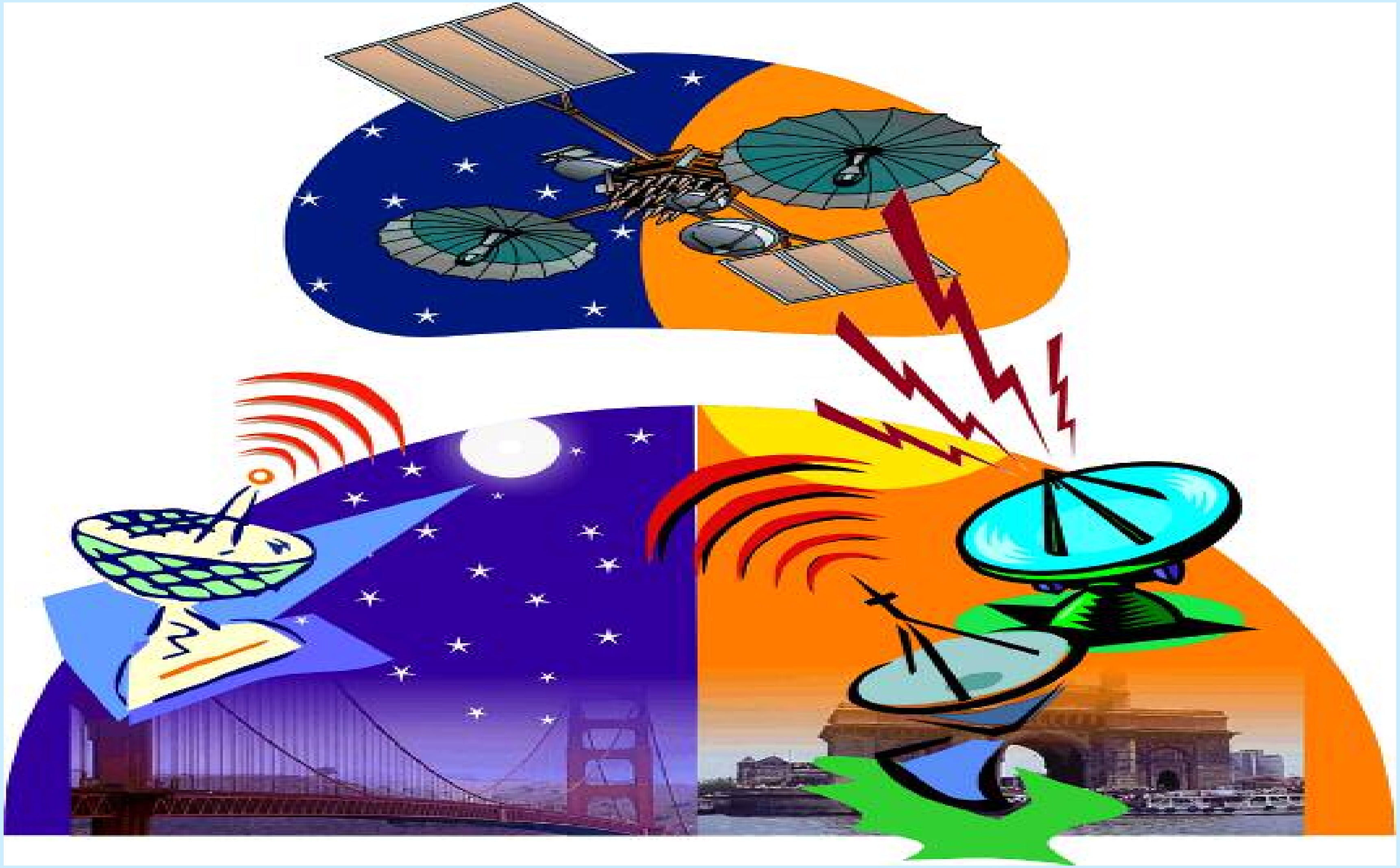
Presentation by : Mr. Ajay Vohra,
Vaish Associates

New Delhi, Tuesday, 29th August, 2006

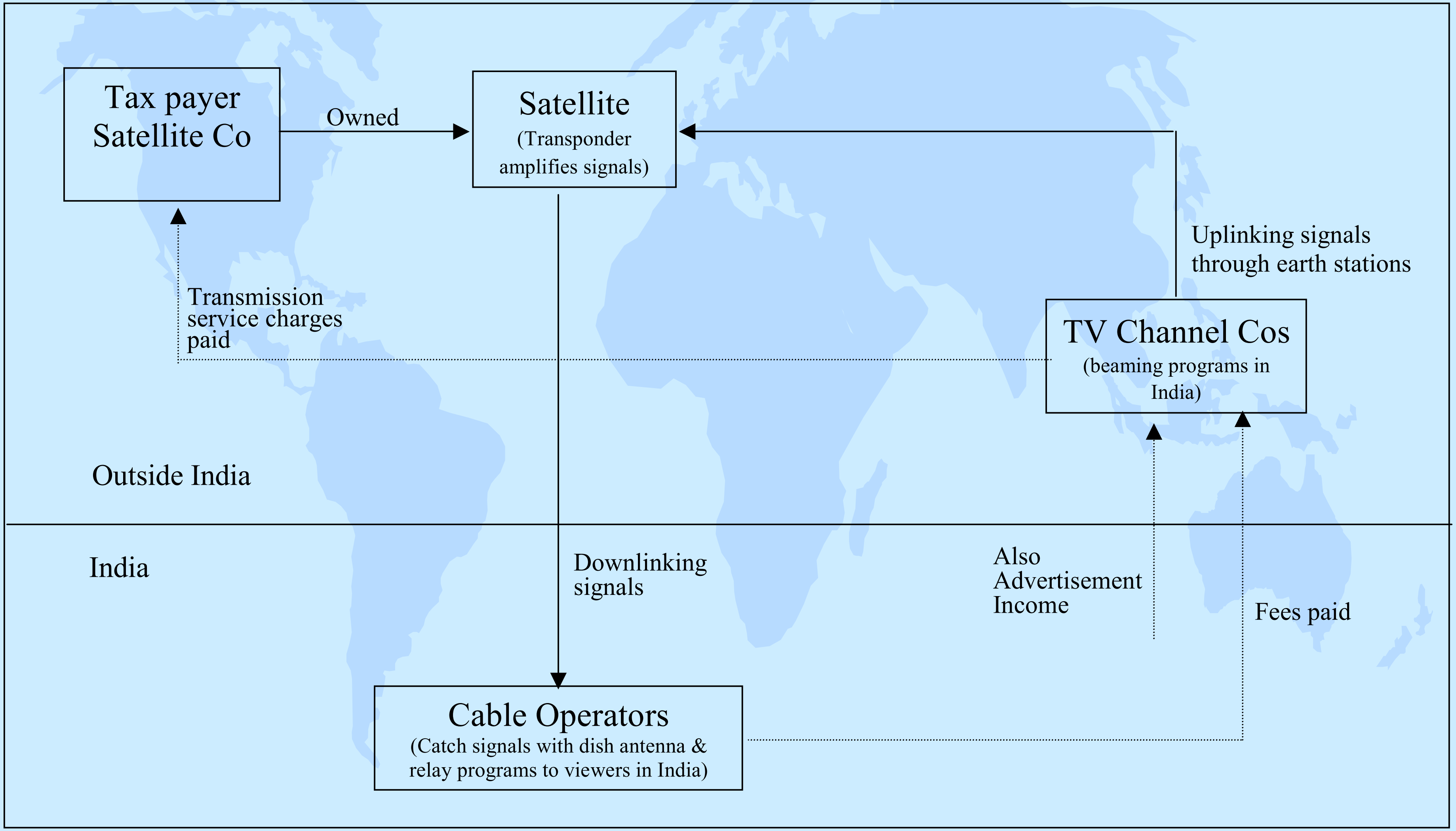
DECISION OF ITAT DELHI BENCH IN THE CASE OF PanAmSat

(ITA NO. 1796/Del/2001)

Satellite Transmission Services



Satellite Transmission Services



REVENUE'S PERSPECTIVE / CONTENTIONS

- The revenues earned by PanAmSat were for the "use of process" and were in the nature of "royalty" under the Income-tax Act and the Treaty
- The TV Channels were using the "process" in India, as the TV viewers, advertisement agencies, from whom revenues were received by TV Channels, were in India
- The revenues were, therefore, held to arise in India as per Article 12(7) of the Treaty
- Dictionary meaning of 'process', viz., "series of actions or steps taken in order to achieve a particular end" referred to

REVENUE'S PERSPECTIVE / CONTENTIONS (Contd..)

- The AO observed that the signals of the broadcasters received by the PanAmSat's Satellite were amplified, transformed from electronic signals into electronic forms, the frequency of signal was modified, the power of the signal is boosted for downward transmission, etc. and the aforesaid set / series of actions was undertaken within the transponder to achieve a result i.e. to make the signal viewable. The said series of steps undertaken within the satellite constituted a 'process'
- Reliance placed on the decision in Asia Satellite Telecommunication Co. Ltd. v. DCIT : 85 ITD 478 (ITAT – Delhi)

REVENUE'S PERSPECTIVE / CONTENTIONS (Contd..)

- It was held in AsiaSat's case as under:
  - No tax treaty with Hong Kong, domestic tax law applicable
  - Non resident TV Channel Cos pay Satellite Co. for use of the process in transponder to relay programmes in India and hence payment was in the nature of royalty under section 9(1)(vi) of the Act
  - Source of income of TV Channel Cos. is from cable operators / advertisers in India and payment made by them to satellite companies is for deriving income from India and hence arises in India as per section 9(1)(vi)(c) of the Act

REVENUE'S PERSPECTIVE / CONTENTIONS (Contd..)

- Alternatively, it was held that the aforesaid revenues were in the nature of 'fees for included services' as referred to in Article 12(4)(b) of the Treaty and were liable to tax in India, as the services were performed in India - the performance of service is where advantage therefrom is derived by the TV channels, viz., India

RELEVANT FACTS

- PanAmSat did not negotiate or receive any revenue from any cable operator or viewer in India
- PanAmSat did not enter into any contract in India
- PanAmSat did not provide broadcasting services. To the contrary, the broadcasters (TV Channels) provided the broadcasting services to their viewers in India and elsewhere
- PanAmSat did not negotiate with or receive any revenue from any company that placed commercials or other advertisements on the broadcasters' programs
- PanAmSat did not own or control either the content transmitted by the broadcasters or the equipment used to transmit such content

RELEVANT FACTS (Contd..)

- The broadcasters or other unrelated third parties (not PanAmSat) owned the uplink and downlink earth stations and other equipment which was used to transmit signals to and receive signals from the satellite
- PanAmSat did not receive the broadcasters' signals in India. Instead, the broadcasters' signals were received by the Satellite in outer space above the Indian ocean at the earth's equator (not above India).
- PanAmSat did not have an office or other fixed place of business in India, did not have employees located in India and did not own property in India
- PanAmSat operated and controlled the Satellite in its active worldwide operating business, all the activities of which were performed outside of India

PANAMSAT'S CONTENTIONS

Characterisation Issues:

I. Payments received by PanAmSat from its customers are properly characterized as payments for the performance of services

- PanAmSat's obligation under its contracts are to accept the signal up-linked by the customer and transmit it to the areas covered by the satellite's footprint
- The services performed by PanAmSat are similar to the services performed by a telephone company
- Skycell Communications Ltd. v. DCIT : 251 ITR 53 (Mad), relied upon
- Payments received constituted business profits not chargeable to tax in India in absence of a PE in India

PANAMSAT’S CONTENTIONS (Contd..)

II. Payments received by PanAmSat are not Royalties within the meaning of the Act / Treaty

<u>Definition of Royalty under the Act</u>

“Explanation 2 – for the purposes of this clause, ‘royalty’ means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head “Capital Gain”) for –

* * *   * * *   * * *   * * *   * * *

the use of any patent, invention, model, design, secret formula or process or trade mark or similar property.”

[Explanation 2 to Section 9(i)(vi) of the Act.]

PANAMSAT'S CONTENTIONS (Contd..)

<u>Definition of Royalty under the Treaty:</u>

"(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright or a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, <u>any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience</u>, including gains derived from the alientation of any such right or property which are contingent on the productivity, use, or disposition thereof; and ………….."

[Article 12(3)(a) of the Treaty]

PANAMSAT'S CONTENTIONS (Contd..)

Payment – whether for 'use of process'

- The items referred to in the royalty definition under the Act or the Treaty, such as copyrights, patents, trademark designs, models, formula, process, information concerning industrial, scientific and commercial experience etc., are all intellectual properties
- Royalty is paid for the use of intellectual property right, which is an intangible property
- From the dictionary meaning of the term "royalty", it appears that the said term connotes payments periodic or at a time for user by one person of certain exclusive rights belonging to another person

PANAMSAT'S CONTENTIONS (Contd..)

- In paragraph 6.17 of the AsiaSat order the Tribunal has held that "all the items referred to in clause (3) of Explanation 2 such as patent, model, formula and process etc., are intellectual properties"

- Payment made by TV Channels is not for use of intellectual property as no such right is made available by PanAmSat for the TV Channels

VAISH ASSOCIATES ADVOCATES
Corporate, Tax and Business Advisory Law Firm

PANAMSAT'S CONTENTIONS (Contd..)

Process vs. Secret Process

- The "Process" has to be secret in the context of royalty as no one will pay for a process which is in public domain
- The phrase "secret formula or process" appearing in paragraph 3(a) of Article 12 of the Treaty must be read, to mean 'secret formula' or 'secret process'
- Placement of comma after the word process and not after the word formula, denotes that secret qualifies both formula and process
- The Treaty definition of royalty is based on the definition of royalty in the United Nations Model Convention

PANAMSAT'S CONTENTIONS (Contd..)

- The word 'secret' is not used with the words, 'information concerning industrial, commercial or scientific experience, referred to in the royalty definition under the Act / Treaty, as they are secret by definition

- The technical explanation to the Indo-US Treaty and the OECD Commentary on Article 12 clarifies that the aforesaid word allude to the concept of know-how and means information, special knowledge that is not publicly available and which one party agrees to impart to another so that he can use them for his own account

PANAMSAT'S CONTENTIONS (Contd..)

- The term "process" finds company with, is of the same genre, and is analogous to, the terms like, secret formula, designs, models, plan, information concerning industrial, scientific experience and would take colour from those words and vice versa, in view of the principles of noscitus a sociis and ejusdem generis

- Contextual interpretation to be preferred - Vienna Convention / Court decision

PANAMSAT'S CONTENTIONS (Contd..)

- The process that is employed in the satellite service is not the concern of the customer
- In any case 'process' is not secret – as it is in public domain
- Revenue received by PanAmSat from its customers is for providing satellite transmission services and not for permitting/allowing use of any "process", much less a "secret process"

PANAMSAT'S CONTENTIONS (Contd..)

<u>Source Rule Issues :</u>

III. Even if payments received are royalties for purposes of Article 12 of the DTA, payments received from non-Indian customers do not arise in India

- The source rule is provided in Article 12(7) of the Treaty and is reproduced as under :

"7. (a) Royalties and fees for included services shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority, or a resident of that State. Where, however, the person paying the royalties or fees for included services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent

PANAMSAT'S CONTENTIONS (Contd..)

establishment or a fixed base in connection with which the liability to pay the royalties or fees for included services was incurred, and such royalties or fees for included services are borne by such permanent establishment or fixed base, then such royalties or fees for included services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated

(b) Where under sub-paragraph (a) royalties or fees for included services do not arise in one of the Contracting States, and the royalties relate to the use of, or the right to use, the right or property, or the fees for included services relate to services performed, in one of the Contracting States, the royalties or fees for included services shall be deemed to arise in that Contracting State."

VAISH ASSOCIATES ADVOCATES
Corporate, Tax and Business Advisory Law Firm

PANAMSAT'S CONTENTIONS (Contd..)

- Paragraph 7(b) of Article 12 of the Treaty applies where under sub-paragraph (a) "royalty or fees for includes services" do not arise in one of the contracting States
- Payment made by US Customers to PanAmSat arise in US under Article 12(7)(a) and cannot arise in India under Article 12(7)(b)
- US Treaties with other countries such as China, Thailand, Australia, having similar clauses and Technical Explanation issued thereon by the US Government referred to

PANAMSAT'S CONTENTIONS (Contd..)

- In terms of paragraph 7(b) of Article 12 of the Treaty, only the 'royalty' payable to PanAmSat by non-U.S customers would be deemed to arise in India, provided the same is payable for the use of, or the right to use, property or rights in India, or for the performance of services in India.
- If the payments are correctly characterized as payments for services, the services are performed by PanAmSat outside India through its Satellite and do not arise in India
- If the payments received by PanAmSat from non-Indian customers are treated as payments for the "use of a "process", the process does not take place in India, as the process is in the Satellite and the Satellite is located outside India

PANAMSAT'S CONTENTIONS (Contd..)

IV. Payments received by PanAmSat are also not fees for technical/included services within the meaning of the Act/Treaty as no technical knowledge, experience, skill, know-how etc. is made available to the TV Channels

DECISION OF THE TRIBUNAL

- The provisions of the Treaty override the provisions of the Income-tax Act and in order to be 'royalties' under the Treaty the payment has to be for the use of 'secret process' and not any process
- The contextual interpretation, having regard to the words preceding and following the word 'process' and the placement of "comma" after word process in the royalty definition under the Treaty suggests that 'royalty' is associated with payment for an intellectual property right and the payment made by the TV channels cannot be said to be for the use of any 'secret process' – the TV channels not being interested in the process which the satellite owner applies in transmitting / relaying the programmes of the TV channels

DECISION OF THE TRIBUNAL (Contd..)

- In any case, that the satellite transmission process is in public domain and has been described in detail in many technical books and is not in that sense a 'secret process'
- PanAmSat was only rendering services viz., satellite transmission services to the TV channels and the payment received from the TV channels was for rendering such services
- The agreements between TV channels and PanAmSat which related to provision of services by PanAmSat to the TV channels were all the same

DECISION OF THE TRIBUNAL (Contd..)

- The Tribunal further held that such services were not in the nature of technical services and were, therefore, alternatively not liable to tax in India as ‘fee for included services’, which expression has been defined in the Treaty to mean rendering of technical or consultancy services which “make available technical knowledge, experience, technical know-how, etc.”
- The Tribunal referred to the decision of the Madras High Court in the case of Skycell Communication Ltd. v. CIT: 251 ITR 53, wherein it was held that provision of cellular mobile service to subscribers did not result in rendering of a technical service and the payment received by the company for providing mobile telephone services was not in the nature of ‘fee for technical services’

DECISION OF THE TRIBUNAL (Contd..)

- Further, no technical knowledge etc. was "made available" by PanAmSat to the TV Channels as they had to go back to PanAmSat to receive such services – Raymond vs. DCIT : 86 ITD 791 (ITAT – Mumbai), referred to

DECISION OF THE TRIBUNAL (Contd..)

On Source Rule

- Prima facie, payment made by US TV Channels to PanAmSat arise in US, and cannot arise in India under Article 12(7)(b) of the Treaty
- Payment by non Indian TV Channels do not arise in India as services are performed where the Satellite is located, i.e., in outer space and not India. Distinction made between source rule under the Act (which refers to the place of use of services) and the Treaty (which refers to place where services are actually performed)

ADVANCE RULING IN THE CASE OF MORGAN STANLEY INC. [REPORTED IN 284 ITR 260]

FACTS

- Morgan Stanley, a tax resident of USA, is a leading investment Bank (having a number of group companies in various parts of the world) engaged in the business of providing financial advisory services, corporate lending and securities under-writing
- The diverse activities are undertaken by various divisions of the company
- Morgan Stanley Advantage Services Pvt. Ltd. (MSAS) was incorporated in India as a wholly owned subsidiary of Morgan Stanley International Holding Inc., USA

FACTS (Contd..)

- MSAS provided following support to Morgan Stanley US and other overseas group entities :
  - Support to front office business units – entities providing back office support to various business units or front offices of Morgan Stanley, viz.,
    - Investment Banking Division ("IBD")
    - Institutional Equities Division ("IED")
    - Equity Financing Services Division ("EFSD") and
    - Fixed Income Division ("IFD")

FACTS (Contd..)

- Support to infrastructure/support units - providing support to various infrastructure/support units of Morgan Stanley, viz.,
  - Equity Research Division ("ERD")
  - Business Information Services Division ("BISD“
  - Information Technology ("ITD")
  - Institutional Securities Group - Marketing ("ISGMD"); and
  - Institutional Data Integrity ("IDID"); and
  - Other infrastructure Groups
- These infrastructure/ support units do not generate any revenues for Morgan Stanley

FACTS (Contd..)

- MSAS did not undertake important revenue generating functions of Morgan Stanley nor bear any significant market risk with respect to its transactions
- The client's interaction was done entirely by the employees / personnel of the Morgan Stanley
- Morgan Stanley also proposed to send its staff to India for stewardship and other similar activities to ensure high standards of quality
- Morgan Stanley briefed MSAS on the standard of services expected, acquainting their staff on various aspects of the functions by conducting briefing sessions for effective transition of various functions and providing basic guidance and monitoring overall outsourcing operations at MSAS

FACTS (Contd..)

- Though Morgan Stanley did not involve itself in the day to day management of MSAS its management infrastructure personnel traveled to India for a very short term to ensure that the establishment and operations of MSAS proceeded without any material exposure

- Morgan Stanley's staff was to be sent on deputation on request to MSAS for periods ranging between several months to a couple of years to work under its control or supervision

FACTS (Contd..)

- MSAS developed computer software including customized electronic data or product of computer programs which were of critical relevance for the various divisions of Morgan Stanley like equity research, fixed income division, equity financing service division, investment banking division, etc.

- The consideration agreed to be paid to MSAS consisted of the cost and a mark-up of a certain percentage of the cost

QUESTIONS BEFORE THE AAR

- Could MSAS be treated as a "permanent establishment" (PE) of Morgan Stanley under Indo US Treay?
- Could Morgan Stanley be deemed to have a PE as a result of sending employees to India or due to deputation of employees to MSAS?
- If there was a PE in India, what was the income attributable to the PE?

CONTENTIONS RAISED BY MORGAN STANLEY

No Fixed Place PE

- No fixed place of business in India through which business of Morgan Stanley is carried on
- The premises of MSAS is used for carrying on the business of MSAS and not of Morgan Stanley
- Morgan Stanley vide agreement dated 1st December, 2003 outsourced certain activities to MSAS and does not carry out its business either wholly or in part in India

CONTENTIONS RAISED BY MORGAN STANLEY (Contd..)

No Service PE

- Not a single person deputed so far
- Deputation of employee by Morgan Stanley in future for sending stewardship functions to ensure stringency quality bench mark of Morgan Stanley
- Employees deputed are not involved in management of MSAS
- Briefing and providing basic training to MSAS Staff

CONTENTIONS RAISED BY MORGAN STANLEY (Contd..)

- The staff in fact renders "quality and risk management services" to Morgan Stanley and not to MSAS
- No service PE constituted as Morgan Stanley send staff for its own benefit, bear the economic burden of salary and other costs while they are in India
- Morgan Stanley does not exercise any control over the operations of MSAS other then the level of control a client would exercise over his service provider

CONTENTIONS RAISED BY MORGAN STANLEY (Contd..)

<u>No Agency PE</u>

- MSAS is not an agent and does not act on behalf of Morgan Stanley
- MSAS while rendering service to Morgan Stanley is conducting its own business
- Principal to principal relationship (as per clause 21.5 of the agreement).
- No authority to conclude contract

<u>Income attribution</u>

- If PE remunerated at arm's length, no further income can be attributed

CONTENTIONS RAISED BY THE REVENUE

- MSAS performs essential and significant activities, which are crucial and critical for the business being carried on by Morgan Stanley as well as the other group companies
- The development of computer software including customized electronic data or product or computer programme are also of critical relevance for Morgan Stanley and the group
- It is on the basis of the material research support, data analysis etc. that the applicant formulates its business strategy and ensures, inter alia, that profits in the share portfolio and fixed income portfolio of customers are increased

CONTENTIONS RAISED BY THE REVENUE (Contd..)

- MSAS would necessarily have business interface on an ongoing basis with vendors of information in the market and have regular contacts with various sources in India for getting the required data and information and other industry specifics for preparing its research reports, review etc. and thus develop in India a network of contacts and sources relating to relevant industry etc.

- The functions performed by MSAS are essential core-functions for the enterprise and cannot be described preparatory and auxiliary in nature

CONTENTIONS RAISED BY THE REVENUE (Contd..)

- The agreement also provides that MSAS is subject to detailed instructions and control with respect to conduct of the business which shows that MSAS is a dependent agent
- MSAS Economically and legally dependent agent to Morgan Stanley following their process and procedures

DECISION OF AAR (Contd..)

No Fixed Place PE:

- The requirements of Article 5(1) of the Treay with USA were not satisfied as there is nothing to show that the business of Morgan Stanley is carried on through the place of business of MSAS
- Use by Morgan Stanley and the other group companies of services of MSAS in running their business does not amount to their carrying on business through the fixed place of business of MSAS – example of foreign automobile company using design made by Indian subsidiary given

DECISION OF AAR (Contd..)

No Agency PE:

- There was no material on record to show that -
  - MSAS was acting in India on behalf of the applicant / Morgan Group;
  - MSAS was a person other than an agent of independent status.
- As MSAS did not (a) have or habitually exercised an authority to conclude contracts on behalf of the applicant; (b) did not habitually maintain stock of goods or merchandise from which it regularly delivered goods on behalf of the applicant; and (c) did not habitually secure orders in India wholly or almost wholly for Morgan Group – there was no agency PE in India

DECISION OF AAR (Contd..)

- The following terms in the service agreement were not found relevant to determine the issue of Agency PE:
  - the agreement between MSAS and Morgan Stanley gives unilateral advantage to the latter with no recompense to the former, if the latter suffers any loss or damage as a result of act of omission
  - right to rescind, amend, assign or enforce the agreement is given only to the recipient company and not to MSAS
  - the obligation of a customer is only to MSAS whereas the customer has no obligation vis-a-vis another
  - the service agreement entered into by Morgan Stanley and MSAS is a unilateral agreement with all disability and disqualification fastened to the supplier alone

DECISION OF AAR (Contd..)

Service PE:

- Deputation of employees to MSAS for more than 90 days there would result a service PE in terms of paragraph 2(l) of Article 5 of Treaty with USA
- The AAR rejected the claim that such employees would be working for Morgan Stanley only
- It may be that the benefit of services of the staff would enure to the applicant but it would not be the same as working for the applicant

DECISION OF AAR (Contd..)

- Once employees are sent by the applicant on deputation for stewardship activities they would be actively involved in the key managerial activities of MSAS as has been pointed out above

- It follows that the ingredients of para 2(l) of article 5 are satisfied and therefore, MSAS would constitute service PE of the applicant/Morgan Group

DECISION OF AAR (Contd..)

Income Attribution

- So long as MSAS, being a permanent establishment of the applicant, was remunerated on an arm's length basis, no further income could be attributed in the hands of the permanent establishment [Ref. Circular No. 23 dated 23-07-1961]
- Whether functions performed by MSAS were core function or non core functioning vis-à-vis Morgan Stanley US not a relevant consideration for determining PE – controversy raised vide circular No. 1/2004 dated 02-01-2004 regarding BPO taxation laid to rest
- Circular No. 5/2004 dated 28-09-2004 relating to BPO reiterates this position

GENERAL

- Whether the ruling of AAR which is binding on both the applicant and the Revenue can be challenged?

- The main attribute of binding ruling is the assurance of certainty to the tax payer; the Revenue should accept AAR rulings

Thank You