Cross-border Transaction – Recent Rulings by AAR

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The imponderables are many in Cross-border Transactions and taxation assumes greater importance because of the uncertainties in the interpretation of tax laws. One cannot be really sure of what is in the offing on the tax-front. The pronouncements by the Authority for Advance Ruling (AAR) have increased the comfort levels of non-residents and foreign companies who would like to have trade relations with their Indian counterpart.

Different types of dealings in Cross Border Transactions have been identified to understand the tax impact in respect of such transactions. Some of the relevant and latest rulings are analysed and a gist of the conclusions reached under different set of circumstances is presented below:

Types of business dealings

For the sake of simplicity the various types of business relations with the non-resident/foreign enterprise can be summarised in the following pattern:

Sale of goods, articles, technical books, CDs, floppies

The non-resident (NR) may be selling plant and machinery, spare parts, raw materials. 'Copy righted' and 'off the shelf' technical books and software CDs and floppies, and also updates and newer versions of the systems having universal applicability. He may also design and develop tailor-made and customised software systems to meet specific needs of a particular user. In all these cases the transaction is one of sale and transfer of property in the goods. Usually the deal is carried out from abroad. To provide greater accessibility to customers, branch offices, sales outlets, and stock points are opened. Moreover local agents also assist the NR to increase turnover.

Agreements for executing projects

The NR may enter into contracts like, turn-key/non-turn-key contracts, a composite contract, Erection Procurement and Construction contracts (EPC), Annual maintenance contract (AMC), contracts for supply of technicians for repairs, erection and installation or providing training for workers either within India or outside. This segment covers both service and supply.

Provision of technical services and transfer of certain rights

The NR may enter into agreement to transfer the right/grant license in respect of or to use any patent, invention, model, design, secret formula, trade mark, or similar property. He may also impart any information concerning technical industrial, commercial, scientific knowledge or skill.

Importance of 'Income Deemed to Accrue or Arise in India'

In order to understand the importance and the relevance of the decisions of AAR, a reference to the meaning of the phrase "deemed to accrue or arise in India" given in Section 9 of the ITA is important. For a clear and distinct understanding of the various types of commercial dealings with the non-resident/foreign enterprise, from a tax angle, the CBDT Circular No. 23{F. No.7A/69-IT (A-II} 23-7-

Nature of transaction	*Remarks*	*Tax Incidence*
1. Non-resident exporters selling goods to Indian importers	Transaction of sale between the two parties on a principal-to-principal basis. Whether immediate or deferred payment	Profit on such transactions not included in the total income of the non-resident
2. Non resident company selling goods to its Indian Subsidiary	The sale is on principal to principal basis, and at arms' length and the subsidiary carries on business on his own instead of functioning as an agent	The mere fact that the Indian Company is a subsidiary of the Non-resident Company; will not be a valid ground for invoking the provisions of section 9
3. An Indian exporter engages the services of a foreign agent who operates in his own country	The commission for the services is directly remitted to him and received by him or on his behalf, and not received by him or on his behalf in India	Such agent is not liable for income tax in India on the commission
4. Sales by a non resident to his Indian customer either directly or through agents	The non resident allows a Indian customer extended credit for payment	No tax liability to the Non-resident if the contract to sell were made outside India and the sales were on principal-to-principal basis.
5. The non resident has an agent in India and makes sales directly to Indian customers and he pays his agent an overriding commission	(i) The agent neither performs nor undertakes to perform any service directly / indirectly in respect of these direct sales (ii) The contract to sell are made outside India (iii) the sales are made on principal to principal basis	Under these circumstances, section 9 cannot be invoked
6. Where orders secured for a non-resident for sales to Indian customers through the services of an agent in India	If the (i) non residents' principal business activities in India are wholly channelled through his agent (ii) contracts to sell are made outside India (iii) the sales are made on a principal to principal basis	The assessment in India of the income arising out of the transaction will be limited to the amount of the profit attributable to the agents' service
7. Where a non resident principal's business activities in India are not wholly channelled through his agent in India		Profits attributable to his agents' activities in India and the profit attributable to his own activities in India less the expenses incurred in making the sales.

(Table 1)

69, clarifying the provisions of Section 9 is analysed in Table 1 *(previous page)*.

As a general rule and guiding principal the circular also stipulates, "if a non-resident has a business connection in India, it is only the portion of the profit, which can reasonably be attributed to the operations of the business carried out in India, which is liable to income tax.

The import of "Permanent Establishment (PE) and Business Connection (BC)"

Having reviewed the various situations under which trade relations are established by a NR and the deeming provision of Section 9, the importance of permanent establishment and business connection may be understood.

The import of these terminologies in the Double Taxation Avoidance Agreements (DTAA) and the Income Tax Act, 1961 (ITA) is to bring to tax the income of the non-resident and the foreign enterprise deemed to accrue or arise in India under the head "Profits and Gains of Business or Profession", with eligible deductions and allowances under the ITA. The tax rate is much higher than that prescribed for specific items of income or service where only tax has to be deducted at source. Once PE is established the procedure of paying advance tax, filing tax return and assessment follows.

Permanent Establishment/ Business Connection

A non-resident/a foreign company is treated as having a PE/BC in India under Article 5 of the DTAA & explanation to Section 9 (1) of the ITA, if the said non-resident/foreign company carries on business in India through a branch, sales outlet etc., or by engaging the services of an agent, other than an independent agent who habitually exercises an authority to conclude contracts, or regularly delivers goods or merchandise, or habitually secures orders in India, on behalf of the non-resident principal. So much of the profits of the non-resident as is attributable to the operations carried out in India are taxable in India.

In the case of *Specialty Magazine Private Ltd. (274 ITR 310),* AAR came to the conclusion that as the applicant, an Indian company whose activities accounted for 75 to 80 per cent of income in relation to the non-resident, and between 20 to 25 per cent in relation to other clients, it cannot be said that the activities of the applicant were carried out wholly or almost wholly for the non-resident company and therefore the applicant was not covered by the definition of PE as per Article 5 of the DTAA and the business profits received by the non-resident company from the applicant were not liable to tax in India under Article 7 of the Convention.

Importance of carrying on an activity in India by the person making payment

Sub clause (c) of clause (vii) of Section 9 (1) provides that if a non-resident making the payment, utilises the services for which payment is made for a business or profession carried on in India or for the purpose of making or earning any income from any source of income in India, in such a situation, the income for the services rendered will be deemed to accrue or arise in India.

In the case of *Airport Authority of India reported in 269 ITR 355,* the US Government offered a resident public sector undertaking, (the applicant) to get a 'feasibility study' conducted of its "air –traffic management requirement". The contractor is a US company who would be paid the contract amount directly out of a grant routed through the Trade Development Authority (TDA). The contractor neither set up any office nor created any permanent base in India. The contractor's experts may briefly visit India to seek inputs/feedbacks. The contractor may also engage the services of some Indian vendors to assist them in collection of data. The final "feasibility report" was prepared and finalised in the USA. The AAR ruled that since the amount is not payable by the applicant (i.e., the Indian public sector enterprise) and the person who made the payment is not carrying on any activity in India, no income can be deemed to accrue or arise in India under Section 9 (1) (vi) or 9 (1) (vii) and opined as the payment to the contractor was made in the USA out of the grant the royalties/fees for included service shall not be deemed to accrue or arise in India.

A non-resident/a foreign company is treated as having a PE/BC in India under Article 5 of the DTAA & explanation to Section 9 (1) of the ITA, if the said non-resident/ foreign company carries on business in India through a branch

An independent agent rendering service in the regular course of his business

When the services of a local bank already in the business of rendering similar services to other customers are availed by a non-resident company to buy, hold and sell shares, the local bank, acting in their normal course of business does not become an agent of the non-resident company. It was established in *Fidelity Advisor Series (viii) by the AAR reported in (271 ITR 1)* that the local bank doing custodial services to a number of local and international customers on a routine basis is an independent agent. And therefore under the circumstances the Non Resident Company cannot be said to have a PE in India.

A designated employee

In the case of *Sutron Corporation (268 ITR 156)*, an US company bagged a contract from the Government of Andhra Pradesh (GOAP) for installation of "remote stations" through the services of an Indian agent. The agent had the authority to submit bids and sign contracts with the GOAP after obtaining due approval from the US company. The agent designated as the country manager was drawing a monthly remuneration. The AAR observed that US Company had a PE in India and as per Article 5 (4) of the DTAA and consequently that part of the income attributable to the operations carried out in India is deemed to accrue or arise in India as per Section 9 (1) of the ITA.

Branch office

Normally a liaison office, simplicitor, not setup for carrying on any business activity will not fall under the ambit of PE.

However, in the case of the UAE Exchange Center, Abu Dhabi set up a liaison office in Kochi, India to offer remittance services from UAE to various places in India for its overseas clients. The liaison office also acted as communication center for its correspondent banks in India. The AAR in *UAE Exchange Center LLC reported in (268 ITR 9)* opined

that the liaison office plays an important role in concluding the transactions even though the commission etc., for the service was received directly by their principals at Abu Dhabi. The AAR therefore came to the conclusion that the establishment of the liaison office constituted a PE and income shall be deemed to accrue in India from the activity carried out by the liaison offices of the applicant in India.

Composite contract

In the case of *Ishikawajima–Harima Heavy Industries Co., Ltd. Japan (271 ITR 193),* where the project was a composite whole, involving offshore supply, offshore services besides onshore supply and services and erection and commissioning the pronouncement was that the activities carried on in India constituted a PE and consequent to the explanation to Section 9 (1) and/or Article 7 (1) of the DTAA between India and Japan Tax the amount that would be taxable in India is so much of the profit as is reasonably attributable to the operations carried out in India.

In the case of sale of goods from outside India, sale is completed outside India and the profit cannot be deemed to accrue or arise in India, unless as explained in the above paragraph, where the consideration is composite and covers not only the price of goods, but also the cost of other operations to be performed by or through the business connection in India in regard to such sale of goods. It is the settled position in law that property in the goods passes to the purchaser when the goods are dispatched and documents of title are handed over to the purchaser unless the parties expressed a different intension in the contract.

The AAR also cited from *Mahabir Commercial Co. limited v CIT (1972) 86 ITR 417 (SC),* the guiding principles for transfer of property in a cross border transaction in a transaction of purchase of goods as below.

"Where in pursuance of a contract the seller delivers the goods to the buyer or to a carrier or other bailee whether named by the buyer or not for the purpose of transmission to the buyer and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract. The buyer's assent to the passing of the property in the said circumstances is implied and when the seller dispatches the goods and delivers them to the common carrier for purposes of transit to the buyer, the common carrier not only receives the goods as agent of the buyer but also assents to the appropriation made by the seller."

DTAA has an overriding effect

The applicant is a resident of UAE and had purchased shares in an Indian company some years back and wanted to sell those shares, which might result in long-term capital gains. The DTAA between India and UAE provide in Article 13 (3) that gains from the alienation of any property other than gain relating to immovable property and business property of a permanent establishment shall be taxable only in the contracting state of which the alienator is a resident. What is sought to be contended here by Tax Department is that the applicant is not taxable in UAE and if by virtue of Article 13 (3) of the Treaty it is not taxed in India, it will lead to a situation where the income is not chargeable to tax in both the countries. It was therefore pleaded that the applicant be taxed in India under the Act. The AAR observed that having regard to Section 90 (2) of the Act the terms of the treaty have overriding effect over the provisions of the Act in the event of there being conflict between the Treaty and the Act. They concluded that in view of Article 13 (3) the capital gains arising to the applicant could be taxed only in the UAE and not in India. Even assuming the capital gain is not chargeable to tax in UAE it will not suffer tax in India by virtue of the provisions in the DTAA. Reference *Emirates Fertilizer Trading Company WII 272 ITR 84.*

Withh olding tax under section 195

A question regarding, whether the payment is royalty or fee for technical services came up for ruling by the AAR in the case of *Dun and Bradstreet Espana S.A reported in 272 ITR 99.* The applicant is a non-resident, incorporated in Spain and it is a subsidiary of an American Co., which is a leading seller of Business Information Report (BIR). An Indian company engaged in a similar business of compiling and selling BIRs in respect of companies under its domain, is owned by a company incorporated overseas where the American Co., also owns 10 per cent in shares. An Indian customer approached the Indian company for BIR about a company in Spain. Arrangements are in place for accessing the server farm in the USA for which the applicant company in Spain charges the Indian company some price worked out on the basis of the average domestic price.

The applicant averred that it did not have a branch in India and the price receivable for allowing the Indian Co., to download the BIR is only a part of its business income covered by Article 7 of the DTAA with Spain. Further it wanted to know whether it would be deemed to have a PE in India and the taxability of the consideration receivable for giving access to electronic data to the Indian customer and whether the TDS provisions are attracted?

The AAR observed, that while determining the relationship between entities the surrounding circumstances should be looked into. Allowing access to its server farm was akin to a sale rather than delegation of sale function to the Indian company. The Indian company while dealing with the applicant company was carrying on its own business and was an independent entity and not an agent and therefore there is no PE. The amounts paid to the applicant were not royalties or fees for technical services within the meaning of Article 13 (3) of the convention. The sale of BIR was akin to sale of a book, which did not involve the transfer of intellectual property. The information was publicly available which was collected and compiled by the associate companies. The BIR was available to any subscriber on payment of requisite price with regular Internet access. Copy right in the BIR was neither licensed nor assigned to either the Indian company or the customer. Hence, it is neither royalty nor fee for technical services. The amount received by the applicant was his business profits under Article 7 and the Indian company not a PE under Article 5 of the Convention. The applicant was not liable for tax on the business profits in India in view of Article 7 read with Article 5 of the Convention.

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Since the payments were not thus taxable there is no obligation on the part of the Indian Company to deduct tax under section195 of the Act.

Sale of software off-the-shelf for use by customers across all countries

While on the subject, it may not be out of place to make reference to a recent decision of the ITAT-Bangalore, in *Samsung Electronics Vs. ITO (2005) 93 TTJ 658* it was held that by acquiring 'off the shelf' softwares the assessee had only received a copy of the copyrighted article, and the copy right remained with the owner, the foreign parties. And the definition of royalty as provided in the DTAAs did not apply and therefore, the remittance made by the assessee for the purchase of software was not an income in India and no TDS was to be deducted under section 195.

Sale consideration in kind

It may be of interest to note the tax treatment for consideration discharged by the allotment of shares in the Indian Company to a NR when he sells plant and machinery. The Board vide its Circular No.382 {F.No.484/12/78FD} dated 4-5-84, clarifies under these circumstances, the income embedded in the payment would attract liability to income tax on recei pt basis since the shares in Indian companies are located in India.

Conclusion

In this article the different types of Cross Border Transactions are summarised and the taxability or otherwise of such transactions discussed by reference to the recent Rulings of AAR, Tribunal Decision and the relevant Notification/Circular. Perhaps this could serve as a reference for ascertaining the taxability of certain transactions. ❐