The Indian company constitutes dependent agent permanent establishment of the US television company

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of NGC Network Asia LLC[1] (the taxpayer) held that the Indian group company of a foreign company has been habitually exercising in India an authority to conclude contracts on behalf of the foreign company which are binding on the foreign company. Therefore, the Indian company has been treated as a dependent agent permanent establishment (DAPE) in India under Article 5(4)(a) of the India-USA tax treaty (tax treaty).

The Tribunal also held that 'advertisement air time' does not fall under the category of 'goods'. The Tribunal observed that the right to procure advertisements for particular airtime, though capable of being transferred, cannot be consumed/used by the buyer of the right, in the absence of any assistance from the taxpayer by way of telecasting the same in the television channels.

Facts of the case

- The taxpayer is a US based company and is a subsidiary of 'Fox Entertainment Group Inc'. It holds 100 per cent shares in NGC Network (Mauritius) Holden Ltd, which in turn, holds 99 per cent shares in NGC Network (India) Private Limited (NGC India). All these companies are either subsidiaries/affiliate companies of News Corporation, USA.
- The taxpayer is the owner of two television channels viz., The National Geographical Channel and Fox International Channel. It is engaged in the business of broadcasting of its channels in various countries including the Indian sub-continent. The taxpayer is eligible for the tax treaty benefit.
- The taxpayer appointed NGC India as its distributor to distribute its television channels and also to procure advertisements for telecasting in the channels. Hence, the taxpayer generates two streams of revenues from India, i.e. (a) Fee for giving distribution rights for telecasting of its channels and (b) Advertisement revenues.
- During the assessment year (AY) 2007-08, two agreements entered by the taxpayer with NGC India in respect of advertisement revenues. As per the old agreement, the taxpayer has given commission at 15 per cent to NGC India and retained 85 per cent of the advertisement revenue. As per the new agreement, it has received fixed amount from NGC India for giving contract of procuring advertisements.
- The taxpayer claimed that both types of income were not taxable in India and accordingly did not offer them in the return of income filed for AY 2007-08.
- The Assessing Officer (AO) held that the advertisement revenues as well as distribution revenues are taxable in India since NGC India is having a DAPE of the taxpayer under the tax treaty. The AO accordingly assessed 25.34 per cent of the advertisement revenues as income of the taxpayer attributable to India, i.e. in the ratio of worldwide profits to worldwide revenue, in accordance with Rule 10B(ii) of the Income-tax Rules, 1962 (the Rules).
- The Dispute Resolution Panel (DRP) upheld the order of the AO.

[1] NGC Network Asia LLC v. JDIT (ITA No. 7994/Mum/2011) – Taxsutra.com

Tribunal's ruling

Whether advertisement air time shall fall under the category of goods

- The advertisement revenue would depend upon the number of advertisements received and also the quantity of air time used. There should not be any dispute that NGC India has acted as an agent of the taxpayer under the old agreement.
- In the case of Ambient Space sellers Ltd[2] it was held that 'Signals' shall constitute goods since they can also be transmitted, transferred, delivered, stored and possessed. In the case of Sun TV Ltd[3] it was held that the right assigned to telecast the programmes in foreign countries either by sale of video cassettes or with the help of satellites are having attributes required for bringing the property involved within the meaning of 'goods' as the same has utility, capability of being bought and sold; and capable of being transmitted, transferred, delivered stored and possessed.
- The 'advertisement air time' is an item that can be identified and abstracted, since the telecasting time limit is predetermined. The right over the advertisement air time may also be capable of being possessed till the time of its expiry. For example, if a person purchases the right over the advertisement airtime of say, 30 minutes to be used before the expiry of a particular month, then the said can possess the right till the expiry of that month. Accordingly, after the expiry of that month, the said right would automatically lapse and hence the characteristic of 'capable of being stored' would have limited application in this case.
- One of the main characteristics of 'goods' is that it should be capable of being 'consumed' or 'used'. There should not be any doubt that the 'advertisement air time' shall have value or capable of being used/consumed only, if the concerned advertisement material is telecast by the taxpayer herein, i.e., the advertisement air time gets is value only if the taxpayer agrees to telecast the concerned advertisement material.
- In the case of 'goods', it gets separated from its manufacturer, and it can be used/consumed by anyone independent of or without any support from the manufacturer. Further, the 'goods' shall be capable of universal use. However, the 'advertisement air time', in the present case, is related to the television channels owned by the taxpayer only.
- The advertisement airtime sold by the taxpayer or NGC India shall not have any value with regard to other television channels, meaning thereby, the same cannot be separated from the taxpayer.
- In the present case the 'advertisement air time' fails to satisfy the test that it is capable of being used/consumed independently, i.e., independent of the taxpayer herein.
- The AO correctly held that the 'advertisement air time' cannot fall under the category of 'goods'. It is only a right given to NGC India to procure advertisements. Though the 'right to procure advertisements' for particular 'airtime' may be capable of being transferred, but the same cannot be consumed/used by the buyer of the right, without the assistance from the taxpayer by way of telecasting the same in the television channels.

Principal and agent relationship

- In the new agreement, it is provided that the relationship between taxpayer and NGC India is that of 'principal to principal', whereas the tax authorities have taken the view that they still continue the 'principal to agent' relationship even under the new agreement also.
- The nature of principal-agent relationship was examined by the Delhi High Court in the case of Idea Cellular Ltd[4]. In a principal to the principal relationship in respect of the sale of goods, the manufacturer does not come in the picture in respect of the further sale of goods. The 'advertisement airtime' does not give to anybody the right of universal use and the same is restricted to the channels owned by the taxpayer only.
- Even after the sale of 'advertisement airtime' by the taxpayer, the purchaser gets only a right to enforce the taxpayer herein to telecast the advertisement material of the purchaser, i.e., taxpayer's concurrence to telecast the advertisements and also actual telecasting alone brings value to the 'advertisement airtime'.
- The taxpayer's involvement till the completion of telecasting of advertisement material is essential in order to maintain the value of advertisement airtime. Hence, 'advertisement airtime' cannot be categorised as 'goods' within the legal meaning of the said term. Accordingly, what is being sold by the taxpayer is only the facility of telecasting of advertisements through the advertisement materials given by the clients.

[2] Ambient Space sellers Ltd v. Asia Industrial Technology Pvt Ltd [1998] PTC (18) (Bom)
[3] CIT v. Sun TV Ltd [2008] 296 ITR 274 (Mad)
[4] CIT v. Idea Cellular Ltd [2010] 325 ITR 148 (Del)

- NGC India cannot be considered to be selling any 'goods' and in effect, it is only canvassing the advertisements for the taxpayer herein. Thus, NGC India provides only agency services to the taxpayer and in turn, the taxpayer is providing advertisement services or telecasting services to the clients.
- The concept of purchase and sale of goods, cannot be applied to the facts of the present case. Accordingly, it was held that NGC India was only enabling the taxpayer to procure the advertisements for telecasting them, and hence cannot be considered as selling advertisement airtime independent of the taxpayer
- Accordingly, NGC India cannot be considered to be 'an independent principal/agent' in respect of dealing in advertisement airtime relating to the television channels owned by the taxpayer.
- In effect, the NGC India was only canvassing the advertisements for the taxpayer through the purchase and sale of advertisement airtime relating to the television channels owned by the taxpayer. It makes NGC India an 'agent' of the taxpayer, since the advertisement airtime, per se, does not have any value without the taxpayer agreeing to telecast the advertisement material.
- It is a well settled proposition that the substance shall prevail over the form and hence even if the new agreement states that the relationship between the taxpayer and NGC India is that of 'principal to principal' basis, it has been observed that the relationship between them actually exists on 'principal to agent' basis only.
- Under the old agreement, the taxpayer paid 15 per cent of the revenue as commission to NGC India and under the new agreement it has sold advertisement airtime for a fixed consideration. The taxpayer has only changed the method of giving compensation to NGC India or method of generating revenue from the broadcasting of advertisements.

Dependent Agent PE

- On a perusal of the various clauses of the new agreement, the Tribunal observed that NGC India habitually exercises in India an authority to conclude contracts on behalf of the taxpayer and the same is binding on the taxpayer since it has agreed to broadcast the advertisements procured by NGC India.
- Hence, NGC India should be classified as 'dependent agent' of the taxpayer in terms of Article 5(4)(a) of the tax treaty. Accordingly, the taxpayer was having PE in India through its dependent agent NGC India in terms of Article 5(4)(a) of the treaty, since NGC India has been given full authority to conclude the contracts in India.

Attributions of profits

- The taxpayer contended that Transfer Pricing Officer (TPO) has held that since transaction entered into is at arms length price (ALP), no further attribution is necessary. Further, the taxpayer relied on various decisions[5]. However, the decisions relied on by the taxpayer was distinguishable on the facts of the present case. The observations made by the Supreme Court in the case of Morgan Stanley shall apply where the payments made by the foreign company to the Indian company for the services availed by it.
- Accordingly, the certification of ALP by the TPO and the decision of various courts would be applicable only in respect of the payments made by a foreign company to its Indian Associated Enterprise (AE) in respect of services availed by it. However, if the foreign company receives any money from the Indian soil and if it is held to be having a PE, then the taxability of the same have to be examined in accordance with the provisions of India-USA treaty as well as under the provisions of Income-tax Act, 1961 (the Act).
- It has been observed that the taxpayer had contended before the AO that it is not taxable at all in respect of advertisement revenue and hence it has been observed that the taxpayer has not challenged the income worked out by the AO. Therefore, in the interest of natural justice, it has been held that the taxpayer should be provided an opportunity to submit its contentions with regard to the computation of income from advertisement revenues.
- Accordingly, for this limited purpose, the issue has been restored to the file of the AO. If the taxpayer does not have to say anything in this regard, the income computed by the AO shall stand.

Taxability of Royalty

- During the year under consideration, the taxpayer generated income through distribution rights of channels. The AO held that the revenue generated on granting of distribution rights was in the nature of royalty and accordingly assessed 15 per cent of thereof as income of the taxpayer under Article 12 of the tax treaty.
- It has been observed that the AO has made a general observation that the Article 12 of the tax treaty shall be applicable without critically analyzing the provisions of the treaty. Though the AO has also referred to the provisions of Explanation 2 to Section 9(1)(vi) of the Act for examining the definition of the term 'royalty', yet the AO has not critically discussed its applicability to the impugned payment.

[5] DIT v. Morgan Stanley & Co. Inc. [2007] 292 ITR 416 (SC), DIT Vs. BBC Worldwide Ltd [2011] 203 Taxman 554 (Del), DIT v. B4U International Holdings Ltd [2015] 57 taxmann.com 146 (Bom)

- The definition of the term ‘royalty’ given in Section 9(1)(vi) of the Act as well as in the India-USA tax treaty uses the expression ‘process’. The said expression has not been defined in the tax treaty, but the same has been defined in Explanation 6 to Section 9(1)(vi) of the Act.
- The aforesaid Explanation has been inserted by the Finance Act, 2012. It had been observed that the various decisions relied upon by the taxpayer had been rendered before the insertion of the Explanation 6 or the applicability of the above said Explanation has not been examined therein. Hence, the question whether the payment received by the taxpayer for giving distribution rights shall fall in the category of ‘royalty’ needs to be examined afresh at the end of the AO.
- Further, while dealing with the issue relating to the advertisement revenue, the High Court held that the taxpayer is having DAPE. The said fact also needs to be taken into account while examining the issue.

Our comments

In the instant case, the Mumbai Tribunal held that the Indian group company of a foreign company has been habitually exercising in India an authority to conclude contracts on behalf of the foreign company which are binding on the foreign company. Therefore, the Indian company has been treated as DAPE in India under the tax treaty.

The OECD BEPS report on Action 7 dealing with the ‘preventing the artificial avoidance of PE status’ recommends an expanded scope of what is proposed to constitute a PE, focusing on the negotiation and final conclusion of contracts. An addition to paragraph 5 of Article 5 is the phrase ‘habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise’. It would be interesting to see how the expanded scope would impact the determination of PE when India will adopt such change in the tax treaties

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

Vadodara
iPlex India Private Limited
1st floor office space
No. 1004, Vadodara Hyper
Dr. V S Marg
Vadodara – 390007
Tel: 0265-2351085 / 2322607

© 2015 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.