

SATURDAY INTERNATIONAL TAX GYAN !!!

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SITG No.
178

M/s Faber Castell Aktiengesellschaft Vs ACIT (IT)

Under India Germany Treaty Royalty is taxable on receipt/ cash basis and not on accrual basis

04.11.2023
Jain Shrimal & Co.

Facts of the Case

- Assessee is a German Company Faber-Castell, world's largest manufacturer of color pencils and pencils.
- Assessee company has entered into royalty agreement with A.W. Faber Castell [India] Pvt. Ltd for use of its trademark in relation to marketing and sale of products procured by FC India for its local operations. FC Germany is eligible to earn royalty and interest income from FC India in respect of the said trademark.
- FC Germany entered into termination agreement with FC India thereby waiving off the royalty liability from F.Y. 2011-12 to 2015-16 to be paid by FC India to FC Germany.
- FC India was facing liquidity crisis and was not able to make royalty payment to FC Germany and FC Germany had inadvertently filed original return of income including royalty income of Rs. 2,36,54,858 on accrual basis which had been waived by the Appellant.

Assessee's Contention

- Revenue has erred in taxing the royalty income that **erroneously offered** to tax amounting to Rs. 2,36,54,858 by the Appellant which had been waived by the Appellant
- Appellant erroneously had offered the royalty income on an accrual basis in the return of income but the same is taxable on a **cash basis** as per the provisions of **India-Germany tax treaty**.
- It is the duty of revenue to charge tax on income correctly and help assessee if he has offered any income tax erroneously.

Revenue's Contention

- An agreement Can not be permitted from the back date since Faber Castell India had already used the brand name and, therefore, income has been accrued. Waiver of royalty is merely an arrangement of convenience between the two related parties and, therefore, the same cannot be of much weightage
- Since royalty is taxed on gross basis, any claim in the nature of bad debts cannot be allowed

Legal Provisions

- **Extract of Section 5 of Income Tax Act:**

(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—

- (a) is received or is deemed to be received in India in such year by or on behalf of such person ; or
- (b) accrues or arises or is deemed to accrue or arise to him in India during such year.

- **Extract of Article 12 of India-Germany DTAA is as under:**

- 1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
- 2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, or fees for technical services, the tax so charged shall not exceed 10 per cent of the gross amount of the royalties or the fees for technical services.
- 3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

Ruling

- The contention of AO that waiving off of Royalty is an arrangement between 2 related party is irrelevant as this arrangement has backing of RBI.
- In case of conflict between the provisions of the DTAA and Act, the provisions contained in the treaty shall prevail. Consequently, it has been held that the taxation of royalty/FTS is on receipt basis. In other words, the amount which has accrued as income to a foreign company cannot be taxed in the source country, being India in this case, unless the amount has been received by the foreign company.
- Hon'ble ITAT while making a decision also relied on the judgement of Pizza Hut International LLC 22 taxmann.com 111 wherein it was held that:
 - *“Thus the initial point of taxation is the arising of the royalty in India, but it is finally taxed on the basis of amount of royalty paid to the non-resident....*
 - *Such interpretation can lead to deferment of payment of tax for some time or for indefinite time. We have considered this matter also. This issue has to be decided on the basis of conduct of the two parties, which are associated enterprises (AEs) in this case.*

Ruling

- It is no doubt true that the provision may be used as a device to defer the tax for any length of time by mutual understanding of the parties. However, to come to such a conclusion in a particular case, the conduct of the parties has to be seen and thereafter a conclusion has to be arrived at that deferment of payment was a device used for the purpose of delaying the payment of tax. No such finding has been recorded in this case. Such is also not the case of Id. Senior D.R.
- Therefore, even if there is force in the argument that the interpretation may lead to delay in payment of tax, it will be useful only in such cases where the AO makes out a case that the delay was with a view to defer the payment of tax.”
- Considering the facts of the case in totality, in light of the judicial decisions discussed here in above, we decide all the grounds of appeal in favour of the assessee and against the revenue. **Accordingly, it was held that royalty and FTS are taxable on payment basis and not on accrual basis.**

Our Comments

- Thus, while deciding on taxability of any income in case of non-resident there are few points which needs to be considered:
 1. Whether the income is taxable in India as per Income tax act.
 2. If yes, then one should check whether India has a DTAA with the residence country of the non-resident.
 3. If yes one need to check in which country such income is to be taxed as per DTAA and whether such income is to be taxed on accrual basis or cash basis and what amount can be withheld in the source country as per DTAA.
 4. Whatever is more beneficial to assessee can be used.
- Further, the words or phrases used in the DTAA needs to be read literally as it is an agreement between two persons and if the agreement says that royalty needs to be taxed when “it is paid”, it needs to be taxed on cash basis and it cannot be taxed on accrual basis even if the local laws tells to tax it on accrual basis.

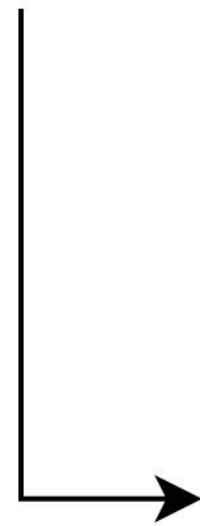


A.W. Faber Castell [India]

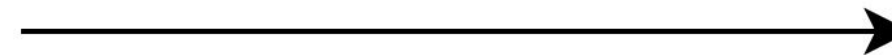


Faber Castell Germany

Faber Castell Germany entered into royalty agreement for use of its trademark



FC
India was facing liquidity crisis and was not able to make royalty payment



FG Castell offered royalty income on accrual basis in the return of Income which has been waived off by appellant

ITAT held that in case of conflict between the provisions of the DTAA and Act, the provisions contained in the treaty shall prevail. Consequently, it has been held that the taxation of royalty/FTS is on receipt basis.

Section/Article	Article 12 of DTAA
DTAA/Country	India- Germany DTAA
Court	IT Appellate Tribunal, Delhi
Date of decision	09.12.2021



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