

Unitika Ltd. Vs. Assistant Commissioner of

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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Nov-29-1994

Reported in : (1995)52ITD249(Delhi)

Judge : V Gandhi, G Agrawal

Appellant : Unitika Ltd.

Respondent : Assistant Commissioner of

Judgement :

1. The appellant, M/s Unitika Limited, is a nonresident company incorporated in Japan. The assessment for the assessment year 1985-86 now under appeal, has been made through Modipon Limited, Modi Nagar, an Indian company with whom the foreign company entered into a collaboration agreement on 21-6-1983 to supply know how and basic engineering facilities stipulated in the agreement. The Indian company remitted a sum of Y 2,26,87,500 to Japan after deducting 56,81,875 as tax at source under the agreement between the two companies. The taxability of above amount is the issue involved in the present appeal.

2. As per collaboration agreement dated 21 -6-1983, Unitika was to provide 'knowhow and basic engineering' to Modipon for manufacturing nylon tyres cord and industrial yarn and the process for commercial production. The aforesaid agreement is divided into ten articles which are made annexures of the collaboration agreement. The terms "knowhow", "know-how and basic engineering documents", "knowhow fees", "basic engineering fees", "effective date", etc. etc.

are defined in Article I. As to what would constitute "knowhow" and "basic engineering documentation" and their delivery schedule is provided in Articles II and III of the agreement. Fees and payment schedule is provided in Article IV. As per Article III of the agreement, the entire knowhow and basic engineering was to be supplied by way of documents containing drawing, designs, data, etc. which were to be delivered in Tokyo, Japan and title in them was to pass to Modipon in Japan in such delivery.

Modipon was granted non-exclusive licence to use knowhow, construct and operate its plan, make products and sell the same anywhere in the world. The entire consideration was fixed at 34,37,50,000 consisting of knowhow fees 21,87,50,000 and basic engineering fee 12,50,000.

The consideration as per Article IV of the agreement was to be paid in three equal instalments. Article 13.1.3 of the agreement provided that the agreement would be effective after the first instalment was paid.

Although original agreement was amended on 27-8-1983 and supplementary agreement was executed on 8-10-1985, the above term relating to effective operation of the agreement continued to be applicable. The agreement was admittedly approved by the Governments and Boards of both the companies. Modipon Limited remitted 25% of first instalment i.e. Y 2,26,87,500 (tax at source 56,71,875) on 7-5-1985. The above amount was 1/12th of the total consideration. It did not make any further payment and it is stated that Unitika Ltd. neither supplied any design, drawing, data, etc. nor rendered any other service.

3. Modipon Limited filed return on behalf of foreign company declaring income of Rs. 13,76,320 on 3-6-1985. However, during the course of assessment proceedings, Modipon claimed that return was filed under a misconception and the same be treated as withdrawn as Modipon could not be treated as agent of the foreign company. The Assessing Officer after referring to terms and conditions of the agreement held that the agreement dated 21 -6-1983 between the parties became null and void as it was not put into effect within 90 days of the signing of the agreement as provided in Article 13.3. There was no further evidence to show that the agreement was approved by Government of India. According to the

Assessing Officer, 25% of the following amounts paid under unapproved and void agreement were taxable :- The above amount at the relevant exchange rate worked out to Rs. 13,76,322. Basic engineering fees worked out by the Assessing Officer at 33,00,000 was liable to be charged at 40% and the balance amount at 20%. However, the Assessing Officer simultaneously observed that above bifurcation was irrelevant as no services were rendered in pursuance to the remittance made and that remittance was not under a valid approved agreement. Thus a special rate of 20% or 40% applicable to "royalty" or "technical services fees" under Section 1 ISA of the Income-tax Act was not applicable. She accordingly subjected the entire sum, i.e., Rs. 13,95,638 to tax without specifying any head.

4. The assessee carried the matter in appeal before the CIT(A) and drew his attention to the terms and conditions of agreement. The assessee sought to raise additional grounds of appeal noted by the CIT(A) in para 10 of his order to the effect that 2,26,87,500 were not taxable income as there was no nexus between the above amount and any business activity carried by the company in India. The assessee further relied upon Double Taxation Avoidance Agreement (DTAA) between India and Japan. The learned CIT(A) observed that additional grounds raised were in conflict with original grounds as per Memo of appeal preferred by the appellant and the Assessing Officer, vide letter dated 29-8-1989 had objected to entertainment of additional grounds. However, as pure question of law was raised in the additional grounds, the learned CIT(A) allowed the assessee to raise those grounds. On merit of the grounds, the learned CIT(A) held that agreement dated 21-6-1983 did not become null and void for nonpayment within the stipulated period of 90 days as the appellant accepted belated payments and had in fact entered into a supplementary agreement on 18-10-1985. He further held that as per written submissions of the assessee, the collaboration agreement continued to be effective even beyond the accounting year under question. In fact, there was no evidence on record to indicate that the agreement had been rescinded by the parties till date. He concluded that payments in question were received on account of services rendered by the appellant. He held that Y 1,03,12,500 were received on account of basic engineering fees and the balance amount 1,80,46,875 on account of technical knowhow fees. The aforesaid amount

was taxable under the Double Taxation Avoidance Agreement (hereinafter referred to as DTAA). On the question whether the assessee had a permanent establishment in India, the learned CIT(A) held that the collaboration agreement was for carrying construction, erection or assembly project in other contracting States, and therefore the assessee would be treated as having a 'permanent establishment'. Accordingly, the learned CIT(A) held that the amount in dispute were taxable in India. In this connection, he referred to Article III (i), X(e), X(f), X(k), Section 115A(b) of Income-tax Act and held that royalty would be taxed at the rate of 20% whereas fees for technical services would be taxed at the rate of 40%. He rejected the contention of the assessee relating to non-taxability of receipt. He further rejected that the agreement became null and void. According to learned CIT(A) the agreement continued to be effective even after the end of the accounting year.

He, however, accepted assessee's contention that for purposes of conversion of Japanese Yen into Indian rupee, the rate as on date of remittance, as per rule 26 of the Income-tax Rules, was to be applied and not the rate as on the last date of the accounting year. Some other minor reliefs were also allowed to the assessee and appeal was treated as partly allowed.

5. The aforesaid order of CIT(A) has been challenged by both the parties. The assessee as per ground No. 4 has specifically urged that learned CIT(A) erred in law in treating Japanese Yen 2,83,59,375 as taxable income in India. The Revenue, on the other hand, in their ground has challenged the finding of CIT(A) that entire amount received by the assessee was not taxable as fees for technical services. Vide application dated 25-7-1994, the assessee raised the following additional grounds of appeal : 1. That on the facts and in the circumstances of the case and in law the Commissioner (Appeals) erred in holding that Unitika Ltd., Osaka, Japan had a 'permanent establishment' in India.

2. That on the facts and in the circumstances of the case and in law the Commissioner (Appeals) erred in holding that knowhow fee paid to Unitika Ltd. was fee for technical services and to be taxed @ 40%.

The aforesaid request of the assessee to raise additional grounds of appeal was opposed by the Revenue. It was contended that issue now being raised was quite different from the plea earlier taken. The grounds further required investigation of facts and, therefore, should not be permitted to be raised. Dr. Devi Paul, counsel for the assessee, on the other hand, contended that matter raised in additional grounds of appeal can be argued under the grounds originally raised, particularly ground No. 4. The additional grounds were raised only as a matter of abundant precaution and to give sufficient notice to the other party. No issue not considered by the CIT(A) was involved in the additional grounds of appeal. No investigation of new facts was necessary. After considering rival submissions of parties and in view of the decision of Hon'ble Supreme Court in the case of Jute Corporation of India Ltd. v. CIT[1991] 187 ITR 688, and of Hon'ble Delhi High Court in the case of Taylor Instrument Co. (India) Ltd. v. CIT [1992] 198 ITR 1, we permit the assessee to raise additional grounds of appeal as the grounds sought to be raised did not involve investigation of new facts. The grounds merely bring into direct focus the aspects already considered by the lower authorities. After allowing the assessee to raise the additional grounds, we permitted both the parties to address us on all the grounds.

6. Dr. Devi Paul, learned senior advocate appearing for the assessee submitted that agreement between the assessee and M/s Modipon was not given effect to as Modipon did not make payment of full amount of first instalment. The company paid only 25% of first instalment. Dr. Devi Paul further submitted that the amount remitted by M/s Modipon cannot be treated as "royalty" or "fee for technical services" as no services were rendered by the foreign company nor any documents were provided as stipulated in the agreement. It was submitted that under the agreement, the assessee was to hand over and transfer in full the documents mentioned in the agreement and not merely the use of licence of documents. In a case where there is outright sale, the payment made cannot be treated as fees for technical services or as royalty. Dr.

Devi Paul read out definitions of above terms provided in DTAA. He also relied upon decision of the Hon'ble Calcutta High Court in the case of CIT v. Davy Ashmore India Ltd. [1991] 190 ITR 626. Dr. Devi Paul argued that the remitted

amount can be taken as business income under the head "Industrial and commercial profits". But for taxing profit under the above head, it was necessary to establish that foreign company had a permanent establishment in India. Dr. Devi Paul vehemently challenged the finding of CIT(A) that foreign company had a permanent establishment in India. It was emphasised that for holding that company had a permanent establishment, it was necessary to show that foreign company carried on construction, erection or assembly of a plant. No activity of aforesaid nature was carried on by the foreign company in India. In fact, agreement did not come into effect. It was accordingly contended that no part of remittance was taxable in India under DTAA. Dr. Devi Paul relied upon and cited decision of Hon'ble Andhra Pradesh High Court in the case of CIT v. Visakhapatnam Port Trust [1983] 144 ITR 146.

7. Shri Abrar Ahmed, learned departmental representative, opposed above submissions. He placed strong reliance on order of CIT(A). Shri Ahmed further read out different Articles of agreement to show that the assessee was to provide knowhow and basic engineering services. M/s Modipon also admitted the remitted amount as taxable income by filing return of assessee-company. The admission was further reiterated in the correspondence filed before CIT(A). Shri Ahmed submitted that entire amount was liable to be assessed as fees for technical services.

8. We have given careful thought to the submissions of the parties. In order to dispose of the appeal, several questions are required to be considered. The first being as to what provision would apply for determining the taxability of the amount remitted. In view of clear provision of Section 90 of the Income-tax Act, as also Circular No. 333 dated 2-4-1982 of CBDT there can be no doubt that income of the assessee is to be computed with reference to DTAA between Government of India and Government of Japan. This view is fully endorsed by decisions of different High Courts and was not seriously disputed before us.

9. The second and most important question is whether the remitted amount could not be taxed as income in India in view of provision of DTAA. It was submitted that the agreements between the parties relating to know-how and basic engineering

services never came into operation.

Our attention, in this connection, was drawn to Article XIII of the agreement which provided as under:- 13.1 This Agreement shall become effective on the last day on which all of the following conditions have been satisfied:13.1.1 ** ** **13.1.2 ** **
** 13.1.3 UNITIKA has received from MODI the payment of first instalment as referred to in Article 4.3.1 hereof.

13.3 If within 90 (ninety) days from said date of signature hereof this agreement shall not become effective pursuant to Article 13.1 above, this agreement shall forthwith become null and void unless otherwise agreed upon by both parties.

Para 4.3.1 referred to above provides that 33% (thirty three per cent) that is 72,187,500 (Japanese Yen seventy-two million one hundred and eighty-seven thousand five hundred only) out of KNOWHOW FEE and 41,250,000 (Japanese Yen forty one million two hundred and fifty thousand only) out of BASIC ENGINEERING FEE, shall be remitted by telegraphic transfer to UNITIKA's account with a bank in Japan designated by UNITIKA. It is thus clear that agreement between the parties was to be effective when first instalment, i.e., 33% of total consideration was received from MODIPON. The said company remitted only 25% of first instalment on 7-5-1984 and did not make any further payment. It is accordingly claimed' that the agreement did not come into effect and, therefore, UNITIKA neither supplied any design, drawing, data, process, etc. nor rendered any other service. The case is that agreement fell through for non-payment of the stipulated consideration. In this connection, assessee further referred to the fact that proceedings for the subsequent year, i.e., for 1986-87 were initiated by the Assessing Officer but were dropped and this fact was accepted that no payment other than the one remitted on 7-5-1984 was made to UNITIKA.10. The learned CIT(A) in the impugned order treated the disputed amount as amount received under the agreement between the parties for the services stipulated in the agreement. He specifically held that agreement between the parties before us, continued much beyond the expiry of the accounting year relating to assessment year 1985-86. In fact, a supplementary agreement was entered on 8-10-1985 which falls beyond the accounting period amending the original arid mandatory

agreement of 27-8-1983. Therefore, "the inference is unescapable that the nature of payments received in pursuance of the agreement and in accordance with the terms contained therein could have to be considered in the light of services rendered by the appellant". We are unable to agree.

11. There is no dispute that on 8-10-1985 a supplementary agreement was entered into between the parties and aforesaid date is much after the end of the accounting period. In that sense, it has to be held that agreement could not be treated as rescinded in the accounting period.

It is nobody's case that agreement was rescinded in the accounting period. The assessee pleaded that agreement did not come into operation as 1/3 of total payment was not paid by Modipon as stipulated in Articles 13.1 and 13.3 of the agreement. As payment was not made, no services were rendered. We are inclined to agree with the aforesaid submission. Neither in the order of CIT(A) nor during the course of hearing before us, the revenue could produce any material to show that MODIPON remitted first instalment (33 1/3%) of consideration to UNITIKA and thus agreement came into operation. Time might not have been the essence of the agreement but payment of 1st instalment as stipulated was mandatory to bring the agreement into operation. In other words, UNITIKA was to supply documents and start stipulated services only after first instalment was paid. As the said sum was never paid, no services as stipulated were rendered and in that sense the agreement never came into operation though part payment of first instalment under the agreement was made.

12. In the above circumstances, we are to see as to what is the nature of amount remitted. The Assessing Officer has not given any clear finding. The learned CIT(A) held the amount partly as "royalty" and partly as "fees for technical services". The assessee has challenged above findings and it is claimed that the amount in dispute at best can be treated as "industrial or commercial profits". The Revenue has contended that the entire receipt is fee for technical services.

13. We find force in contention of Dr. Devi Paul that the remitted amount could only be treated as "industrial or commercial profits" and not as "fees for technical services" or "royalty". The above terms under the DTAA are defined as under :

Article X(e). Royalties and similar payments paid as consideration for the use of, or for the right to use, in one of the Contracting States, any copyrights, artistic or scientific works or equipments, patents, designs, secret processes and formulae, trade marks, cinematographic films (including films for use in connection with television and other like properties) and fees for technical services rendered in that connection, shall be treated as income from sources within that Contracting State.** ** ***** ** ** X(k). Fees for technical services payable to an enterprise shall be treated as income from sources within the Contracting State in which are rendered the services for which such fees are paid.

It is clear from the above definition of 'Royalty' that it is consideration for use of copyright, work, design, patent, etc. The extended definition would include fees for technical services rendered in that connection in the contracting State. In other words, for purposes of Article X(e) the property in the copyright or other work should continue to remain with the owner but its use is permitted for a consideration. In the present case, the agreement stipulated out right transfer of designs from UNITIKA to MODIPON and on such delivery of the documents in Japan, the MODIPON was to become owner of the designs, documents. It was not to pay any fees for use of the documents/designs.

Thus the amount stipulated in the agreement could not be termed as consideration for use of documents to fall within the definition of 'royalty'. The above view is fully supported by the decision of Hon'ble Calcutta High Court in the case of Davy Ashmore India Ltd. (supra). The documents were never delivered to the MODIPON as first instalment of the total agreed sum was not paid nor any services rendered. In our considered opinion, for holding any amount as "royalty" or "fees for technical services" it is necessary to establish that actual services were rendered. The remitted amount, therefore, could also not be treated as "royalty" or "fees for technical services".

14. Dr. Devi Paul, counsel for the assessee conceded that amount could be treated as a "business income" of the assessee having been received in the course of carrying on of a business. Under DTAA, the remittance could fall under the terms "industrial or commercial profits". However, for taxing the receipt under

the above head, it is necessary to show that the assessee had a "permanent establishment" in India. The term "permanent establishment" is defined in DTAA as per Clause (0 of Article II (I) as under : Article II (I) (i) the term "permanent establishment" means a fixed place of business in which the business of an enterprise is carried on; (i) the term "fixed place of business" shall include a branch, an office, a factory, a workshop, a warehouse and a mine, a quarry or other place of extraction of natural resources; (ii) an enterprise of one of the Contracting States shall be deemed to have a fixed place of business in the other Contracting State if it carries on in that other Contracting State a construction, erection or assembly project of the like; (iii) the use of mere storage facilities or the maintenance of a place of business exclusively for the purchase of goods or merchandise and not for any processing of such goods or merchandise in the country where such purchase takes place shall not constitute a permanent establishment; (iii-a) an enterprise of one of the Contracting States shall not be deemed to have a permanent establishment in the other Contracting State if it maintains a fixed place of business solely for the purpose of advertising, for the supply of information or for scientific research, being activities solely of a preparatory or auxiliary character in the trade or business of the enterprise; (iv) a person acting in one of the Contracting States for or on behalf of an enterprise of the other Contracting State shall be deemed to be a permanent establishment in the former Contracting State, if A. the person has and habitually exercises in the former Contracting State a general authority to negotiate and conclude contracts for or on behalf of such enterprise, unless the activities of such person are limited exclusively to the purchase of goods or merchandise for or on behalf of such enterprise, or B. the person habitually maintains in the former Contracting State a stock of goods or merchandise belonging to such enterprise from which such person regularly delivers goods or merchandise for or on behalf of such enterprise, or C. the person habitually secures orders in the former Contracting State exclusively or almost exclusively, for the enterprise itself or for such enterprise and other enterprises which are controlled by it or have a controlling interest in it; It is an admitted position that Sub-clauses (i), (iii), (iii-a), and (iv) are not attracted. According to the learned CIT(A) Sub-clause (ii) is attracted and the assessee would be deemed to have 'permanent establishment' in India as it was to

construct, erect and assemble project for MODIPON, In our considered opinion, the aforesaid sub-clause is not applicable as the assessee did not carry any construction, etc., in India for MODIPON. The expression "carries" denotes actual carry on of "construction", "erection", "assembly of project" and would not cover a "would have carried on" situation if terms and conditions of the agreement were fulfilled. If no activity of aforesaid nature is actually carried, the sub-clause is not attracted.

The agreement did not come into effect. Thus, for purposes of Sub-clause (ii), the condition relating to actual carrying of construction activity in the Contracting State was not fulfilled. It is a deeming provision and is required to be construed strictly and cannot be expanded to cover situations not provided for. The words "carries" cannot be substituted by words "would have carried". The conditions for the legal fiction to operate in the sub-clause are not satisfied.

Therefore, the assessee cannot be deemed to have a "permanent establishment" in India as envisaged in Sub-clause (ii). The learned CIT(A) while holding to the contrary, did not show that the assessee actually carried on activities mentioned above. He merely referred to the agreement which in his opinion operated much beyond the accounting period. He did not refer to the mandatory term relating to payment of 1/3 of total consideration nor considered effect of failure to observe it. In our considered opinion 31-3-1985 could not be treated as a cut-out date and it was necessary to look beyond the accounting period to determine what services were rendered which in turn determined the character of the remitted amount. Even for period ending 31-3-1985, it was necessary to consider whether the agreement was put into operation and services were performed thereunder. There is no justification for presuming rendering of any service. The remitted amount was part of advance for promised services. The case was similar to forfeiture of any advance under a trade contract for failure to observe mandatory conditions of the contract. The remitted amount having been received in the course of carrying on of business at best could be treated as business receipt and not as "royalty" or "fees for technical services".

In above view of the matter, we hold that learned CIT(A) was not right in treating the disputed amount as taxable as royalty or fees for technical services. The amount could be taken as industrial or commercial profits.

15. For the aforesaid reasons, we hold that amount remitted by MODIPON to the assessee could not be charged to tax under the provision of Double Taxation Avoidance Agreement (DTAA) Act. In the light of aforesaid finding, it is unnecessary for us to deal with other grounds raised by the parties.

16. In the result, assessee's appeal is allowed in terms stated above whereas the appeal filed by the revenue is dismissed.

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