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Tax alert: Lease income taxable on receipt basis

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The Delhi Bench of the Income-tax Appellate Tribunal, based on facts, has held that income from leasing of helicopter was not taxable under Article 12(3) of India-UAE tax treaty, as no royalty income was actually received by the taxpayer during the year under consideration.

In a nutshell

As per the definition of royalty under Article 12(3) of the India-UAE tax treaty, royalty income has to be received for use or right to use of any copyright, trademark, patent etc.

The expression 'received' used in Article 12(3) of India-UAE tax treaty, read in conjunction with Article 12(1) and Article 12(2) of the India-UAE tax treaty, means 'actual receipt' of royalty and not any receipt on accrual or deemed basis.

It may be noted that as no royalty income was received by the taxpayer, the ITAT did not go into the issue, as to whether the lease amount could be treated as 'equipment royalty' both under the domestic law as well as under the India-UAE tax treaty provision.

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Background:

- The taxpayer[1] is a non-resident entity incorporated under the laws of United Arab Emirates (UAE) and engaged in the business of leasing of helicopter to the clients across the world.
- During the Financial Year (FY) 2014-15, corresponding to Assessment Year (AY) 2015-16, the taxpayer filed its return of income and claimed that the amount received, being in the nature of business income, was not taxable in India, in absence of a Permanent Establishment (PE) in India.
- During the course of audit proceedings:
  - The Assessing Officer (AO) observed that the taxpayer had leased one helicopter to an Indian company (I Co) through a dry lease agreement executed on 13 July 2012 for a period of three years. As per the agreement, the taxpayer transferred the right to use/operate the helicopter in India.
  - Thus, the AO issued a show-cause notice to the taxpayer to explain, why the lease charges received from leasing of the helicopter should not be treated as royalty under Article 12 of India-UAE tax treaty, read with section 9(1)(vi) of the Income-tax Act, 1961 (ITA) [relating to taxation of 'Royalty' income].
  - The taxpayer contended that it had simply given lease of asset (helicopter) to an Indian entity and not any license or privilege to use an intellectual property in the asset. Thus, the lease rental could not be taxed as royalty, either under the ITA or under the India-UAE tax treaty provisions.
  - However, the AO was not convinced with the taxpayer's contentions and held as follows:
    - As per Explanation 2(iva) to section 9(1)(vi) of the ITA, the word 'equipment' is neither defined under the ITA, nor under the tax treaty. The dictionary meaning of the word had to be adopted and hence the lease of helicopter would fall under the definition of 'royalty' as per section 9(1)(vi) of the ITA.
    - Even under Article 12(3) of India-UAE tax treaty, the income from leasing of helicopter was taxable in India.
    - Some other tax treaties, such as, India-Ireland and India-Netherlands tax treaties specifically exclude use of aircraft from the definition of royalty, which was not the case in India-UAE tax treaty.

  Accordingly, the AO held that the lease amount would be taxable as 'Royalty' in India and completed the assessment.
- Aggrieved, the taxpayer filed an appeal and in the course of audit proceedings, the matter reached the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

- **Article 12 of the India-UAE tax treaty (relating to Royalties)**

  "The term "royalties" as used in this Article means payment of any kind received…

  … for the use of, or the right to use, industrial, commercial, or scientific equipment…"
- **Relevant extract of section 9(1)(vi) of the ITA**

  "Income deemed to accrue or arise in India.

  9. (1) The following incomes shall be deemed to accrue or arise in India:-…

  …(vi) income by way of royalty payable by-…

[1] Aircon Beibars (FZE) v. DCIT, Circle-1(1)(1), (IT) [2023] 153 taxmann.com 41 (Delhi-Trib.)

…(b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India;…

…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 gains") for—…

…(iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;…"

Decision of the ITAT:

The ITAT acknowledged that the issue for consideration was whether, the lease income received by the taxpayer towards leasing of a helicopter, was taxable as royalty income under the provisions of ITA as well as under the India-UAE tax treaty provisions. In this regard, the ITAT noted / observed as follows:

Dispute between taxpayer (lessor) and I Co (lessee)

- During the year under consideration, the taxpayer had raised only four invoices for the months of April 2014 to July 2014.
- Due to serious dispute between the parties regarding the terms of lease and other issues, the taxpayer did not receive any payment towards leasing of the helicopter from the lessee, including the amount for which aforesaid four invoices were raised.
- The parties went into litigation on the issue of implementation of the terms of lease agreement through arbitration proceeding and thereafter before the Bombay High Court.
- Though an arbitration award was passed for sale of the helicopter to the lessee, however, ultimately, the sale of helicopter did not happen as the taxpayer challenged the arbitration award before the Bombay High Court which stayed the arbitration award.

Form 26AS reflected tax deducted on the lease charges

- Form 26AS of the taxpayer (a statement providing details of tax deducted/paid on various source of income of a particular taxpayer) was reflecting certain amount as the income paid/credited to the taxpayer, since the lessee deducted tax on the said amount. In reality, the taxpayer did not receive even a single amount towards the lease income.

Based on the aforesaid factual position the ITAT observed that it was to be decided whether the alleged royalty income was taxable in the hands of the taxpayer on notional basis.

Whether royalty income, being not received, taxable in hands of taxpayer?

- As per Article 12(1) of India-UAE tax treaty, royalty income **paid** to a resident of another contracting State is taxable in that State.
- However, Article 12(2) provides that such royalty income arising in the source State can also be taxed in the source State in accordance with domestic law of that State. However, if the recipient of royalty income is a beneficial owner, the tax chargeable shall not exceed 10% of the gross royalty income.
- Article 12(3) of the India-UAE tax treaty defines the term **'royalty'** to mean, **payment of any kind received** as a consideration for the use of or the right to use of copy right, patent, trademark, secret formula, processes, industrial, commercial, or scientific equipment, etc.
- Hence, as per the definition of royalty under Article 12(3) of the India-UAE tax treaty, the royalty income has **to be received** for use or right to use of any copyright, trademark, patent etc.

- In the case under consideration, no income was received by the taxpayer from I Co, which was also accepted by the Revenue authorities. Accordingly, the condition under Article 12 of India-UAE tax treaty was not fulfilled. In earlier ruling[2], the Mumbai Bench of the ITAT dealt with pari materia provision contained in the India-USA tax treaty.
- In any case of the matter, the receipt of lease income was fraught with uncertainties as parties were in dispute and litigations were pending for past so many years. Even, there was no likelihood of end of the litigation in near future. Hence, in such scenario it could not be said that the taxpayer received any royalty income, either under the domestic law or under the treaty provisions.
- Further, the expression **'received'** used in Article 12(3) of India-UAE tax treaty read in conjunction with Article 12(1) and Article 12(2) of the India-UAE tax treaty meant **'actual receipt'** of royalty and not any receipt on accrual or deemed basis.
- Thus, the royalty income could not be added on notional basis. Hence, the AO was directed to delete the addition.

In view of the aforesaid, the ITAT deleted the addition holding that the lease amount was not taxable under Article 12(3) of India-UAE tax treaty as no royalty income was actually received by the taxpayer during the year under consideration.

Comments:

Certain articles in a tax treaty are worded to cover within the ambit of taxation only that amount of income (such as Royalty, fees for technical services, dividend, etc) which has been received by the taxpayer. Whether in such cases the income should be taxed on accrual basis or on receipt basis has been a subject of litigation.

The ITAT in this ruling, in the context of analysing the India-UAE tax treaty and based on facts has held that:

- As per the definition of royalty under Article 12(3) of the India-UAE tax treaty, the royalty income has to be received for use or right to use of any copyright, trademark, patent etc.
- The expression 'received' used in Article 12(3) of India-UAE tax treaty read in conjunction with Article 12(1) and Article 12(2) of the India-UAE tax treaty meant 'actual receipt' of royalty and not any receipt on accrual or deemed basis.

It may be noted that as no royalty income was received by the taxpayer, the ITAT did not go into the issue, as to whether the lease amount could be treated as ‘equipment royalty’ both under the domestic law as well as under the India-UAE tax treaty provision.

Taxpayers with similar facts may evaluate the impact of this ruling to the specific facts of their cases.

[2] ADIT (IT-3) v. Johnson & Johnson [2013] 32 taxmann.com 102 (Mum-Trib.)

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