Compensation received under an arbitral award not "Other Income"

By: Ravi S. Raghavan, Partner, Tax and Private Client Group, Majmudar & Partners, India

Background

In 1998, Mahanagar Telephone Nigam Limited ("**MTNL**") invited tenders for Code-Division Multiple Access ("**CDMA**") technology supply on a turnkey basis. In 1999, a contract was awarded to a joint venture between Fujitsu Ltd. ("**Fujitsu**"), a tax resident of Japan, and Fujitsu India Private Limited ("**FIPL**"), with FIPL designated as the lead partner. The project involved the supply of equipment and commissioning of a CDMA system for MTNL.

A dispute arose from the non-payment of dues under various purchase orders after commissioning and acceptance testing of the CDMA system by MTNL. In 2009, Fujitsu and FIPL invoked the arbitration clause and commenced arbitration proceedings against MTNL. During the assessment year 2019-20, Fujitsu received from MTNL compensation of the principal amount along with interest. In its tax return, Fujitsu classified the principal amount as "business income" and asserted that it was not taxable in India in the absence of a permanent establishment in India as per Article 5 (that deals with a place of business of a foreign enterprise) read with Article 7 (that deals with business profits of a foreign enterprise) of the double taxation avoidance agreement between India and Japan (the "**Japan DTAA**"). The interest income was offered to tax at the concessional rate of 10% under Article 11 of the Japan DTAA. The Indian income tax authorities (the "**ITA**") disputed this classification and treated both, the principal and the interest component, as "Other Income" under Article 22 of the Japan DTAA.

Generally, income (other than dividend income, interest income, business profits, royalty income, fees for technical services, fees from dependent personal services and fees from independent personal services) that is not explicitly dealt with in a double taxation avoidance agreement gets covered in a distinct residuary section known as "Other Income." The "Other Income" residuary category encompasses various types of earnings that may not fall under the specific terms of a double taxation avoidance agreement. As per paragraph 3 of Article 22 of the Japan DTAA, the exclusive right to tax "Other Income" has been given to the State of residence of the taxpayer (India, in this case).

The ITA argued that the compensation was a one-time windfall, non-recurring gain that did not arise directly from the regular business operations of Fujitsu. Further, Fujitsu did not incur any business expenses in India in relation to this compensation, which suggests the passive nature of the income as opposed to active business income. On this basis, the ITA alleged that Article 7 of the Japan DTAA relating to "Business Profits" was inapplicable due to Fujitsu's lack of substantial business operations in India.

The Delhi tribunal's ruling

After a detailed analysis of the arbitration proceedings and the contract, the Delhi Income-tax Appellate Tribunal (the "**Delhi ITAT**") noted that Fujitsu was indeed a necessary and

96, Free Press House, 9th floor, Free Press Journal Road, Nariman Point, Mumbai 400 021, India
Tel: +91 22 6123-7272;
Other Office – Bangalore | Integrated Network Offices – Chennai, Hyderabad and New Delhi
www.majmudarindia.com

integral party to the project contract. The Delhi ITAT based its assessment on the fact that, since 1998, Fujitsu had been providing telecom and information technology-based solutions to various clients globally. Fujitsu and FIPL formed a joint venture to bid for the MTNL contract, which the joint venture had won, following which Fujitsu had executed the project contract in the ordinary course of its business.

The arbitral award was on account of a dispute relating to the supply of equipment by Fujitsu; and, accordingly, the principal compensation under the award arose from Fujitsu's core business activities and retained its character as business income under the Japan DTAA. Moreover, as the supply transaction was a trading transaction, and as Fujitsu did not have a permanent establishment in India, this income could not be taxable in India.

The Delhi ITAT followed the Supreme Court's decision in the *Govinda Choudhary* tax case and held that the interest income was only an accretion to the taxpayer's receipt from the contract. Therefore, it shared the same character as the principal compensation under the contract which the taxpayer was entitled to. Thus, the interest income could not be separated from the other amounts granted to a taxpayer under an arbitral award and treated as "Other Income."

Our comments

The characterisation of a one-off receipt as coming under the scope of business activities has often been a contentious issue as the tax implications can differ based on the nature of the receipt. In the *Glencore International AG* tax case, on principles of interpretation, the Delhi High Court, by its order dated July 31, 2019, held that compensation received by a Swiss company (the decree holder) as damages for breach of contract in India was not in the nature of a "windfall gain" and, therefore, not taxable under Article 22 (Other Income) of the India-Switzerland double taxation avoidance agreement. The Delhi High Court also rejected the position taken by the ITA in the *Glencore* case that the award for arbitration and legal costs constituted fees for technical services as the award was not the income of the decree holder. The Delhi High Court also held, in this case, that the interest paid on the award was not taxable under Article 22(3) of the India-Switzerland double taxation avoidance agreement.

The Delhi ITAT's ruling has recognized that the compensation under the award was inextricably linked to Fujitsu's commercial activities in India and has clarified on the manner in which such one-off payments of compensation for breach of contractual rights should be dealt with.

96, Free Press House, 9th floor, Free Press Journal Road, Nariman Point, Mumbai 400 021, India
Tel: +91 22 6123-7272;
Other Office – Bangalore | Integrated Network Offices – Chennai, Hyderabad and New Delhi
www.majmudarindia.com