Amount received by non-resident from its Indian franchisees towards reimbursement of international sales and marketing expenses is royalty/FIS as per India-US tax treaty

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In brief

Recently, the Mumbai Income-tax Appellate Tribunal (the Tribunal) held in the case of Marriott International Inc. (Marriott Inc. or taxpayer) that amounts received by the taxpayer from various Indian hotels operating under the 'Marriott' and/ or 'Renaissance' brands as reimbursements for undertaking international advertisement and marketing programmes for these brands, were in the nature of royalty and fees for included services (FIS). Furthermore, it held that the agreement entered into was in the nature of a 'colourable device' adopted for the purposes of tax planning.

In detail

Facts

The appeal filed by the taxpayer,[1] pertained to the assessment years (AYs) 2006-07 to 2009-10. The appeals were consolidated for the sake of convenience, since the issues agitated in the appeal were similar. AY 2006-07 was taken up as the lead case by the Tribunal.

The taxpayer, incorporated in and a tax resident of the USA, belonged to the 'Marriott Group', which was engaged in the business of operating hotels worldwide under brands such as 'Marriott' and 'Renaissance '. The Marriot Group also gave licenses to other hotels under a franchisee arrangement to enable them to carry out business under these brand names.

Marriott Worldwide Corporation (MWC), an affiliate company belonging to the Marriott Group, had entered into a "license and royalty agreement" with another Group entity (name of entity was not available) that owned the Renaissance and Marriott brands. Under the authority of this agreement, MWC gave permission or a licence to other hotels to use these two brand names upon the payment of royalty on agreed terms. Three Indian companies Juhu Beach Resorts Limited, Chalet Hotels Limited and V M Salgaonkar and Brothers Private Limited (hereinafter referred to as the 'Indian Companies') engaged in the business of running hotels, had entered into an agreement with MWC for use of either or both these brand names. MWC had offered the royalty received from the Indian Companies as its income in India, and the same was not disputed.

Separately, the taxpayer had also entered into an international sales and marketing agreement ('ISMA') with the aforementioned Indian companies, under which the taxpayer had agreed the following:

[1] Marriott International Inc. *v.* Dy.DIT [TS-4-ITAT-2015(Mum)]

- **Taxpayer to provide international sales and marketing services** – The taxpayer was to be reimbursed by the Indian Companies at a fixed percentage of the gross revenue of the Indian Companies. This consideration was considered as the allocable share of actual costs and expenses incurred by the taxpayer towards the rendering of the international sales and marketing services (Article 2.01 of the ISMA);
- **International sales and marketing fees** – Sales and marketing fees were to be paid to the taxpayer (over and above the actual cost and expenses mentioned above) as a percentage of the gross revenue of the Indian Companies (Article 2.05 of the ISMA); and
- **Reimbursement of expenses by the Indian Companies to the taxpayer for provision of special services *viz.* special chain services, reservation system, advertising costs** – The expenses incurred by the taxpayer were to be charged to the participating Indian Companies on a fair and reasonable basis (Article 2.02 to 2.04 of the ISMA).

The taxpayer filed its return of income for AY 2006-07 treating all the above receipts as taxable. Subsequently, the taxpayer filed a revised return of income declaring 'nil' income and sought refund of the taxes withheld by the Indian Companies, on the ground that the said expenses were in the nature of reimbursement of expenses, on a cost-to-cost basis (without any mark-up) and hence were not taxable.

In course of the assessment proceedings the tax officer (TO) held as follows:

Amount received towards:	TO held as:
Payment for international sales and marketing services	Taxable as 'royalty' since it was in the nature of consideration for using the brand name of the Marriott Group.
Payment as international sales and marketing fees	In the nature of 'managerial fees' under section 9 of the Income-tax Act, 1961 (the Act) and in the category of FIS under Article 13 of the India-US Double Taxation Avoidance Agreement (tax treaty).
Payment for reimbursement of expenses	In the nature of FIS as in Article 13 of the India-US tax treaty.

The TO also charged interest under section 234B of the Act for non-payment of advance tax.

Aggrieved by the TO's order, the taxpayer filed an appeal with the Commissioner of Income-tax (Appeals) [CIT(A)]. The CIT(A) had, in his order:

- Accepted the TO's view and held that payments received by the taxpayer under Article 2.01 were taxable as royalty, and those received under Article 2.02 to 2.04, were taxable as FIS.
- The receipts under Article 2.05 were taxable as royalty and not FIS as the TO held.

Aggrieved by the CIT(A)'s decision, the taxpayer filed an appeal before the Tribunal.

Issue before the Tribunal:

Whether the sums paid by the Indian companies to the taxpayer towards reimbursement of international sales and marketing services was in the nature of 'royalty' and/or 'fees for included services' under section 9, of the Act, and whether the Marriott Group had bifurcated the 'royalty' amount into more than one component.

Taxpayer's contentions:

- The CIT(A) had erred in concluding that payments received for reimbursement of international sales and marketing services were in the nature of royalty and/or FIS;
- The impugned payments received by the taxpayer were mere reimbursement of expenses. Though the agreement provided for payment of expenditure/ cost in providing international sales and marketing services under Article 2.01 and for the payment of fees under Article 2.05 as a percentage of gross revenue, yet the surplus, if any, that was available after incurring the concerned expenses, was either refunded to the hotels or included in the next year's spending. The taxpayer was allocating the expenses and costs incurred for marketing programs on an actual basis without adding any mark-up for profit. Accordingly, the taxpayer did not make any profits out of these amounts. These payments had been made for specific services which were unconnected with the payment of royalty to MWC;

- The Government of India had approved the payments to be made by the hotels towards royalty as well as towards international sales and marketing fees, and the same included approval for the reimbursement of costs from the Exchange Earner's Foreign Currency (EEFC) account for international sales and marketing costs covered by Articles 2.01 to 2.04. Accordingly, the said approval made it very clear that the taxpayer hotels were making different kind of payments, i.e., towards royalty, reimbursement of expenses, fees, etc. As each payment was made for specific purposes, all of them could not be considered as royalty or FIS. As such, the tax authorities were not correct in taking a stand which contradicted the approval given by the Government of India. The Government of India had authorised payment of royalty to a different affiliate of the Marriott Group and not to the taxpayer company.

- The services provided by the taxpayer under the ISMA included the "frequent traveller programme", and the "reservation programme", both of which had nothing to do with the brand. The parties to the agreement had understood the terms and conditions of the agreement in a particular manner, and had also acted in that manner. It was not open to the TO to give another interpretation and tax the taxpayer. In this regard, reliance was placed on the decision of the Calcutta High Court in the case of Arun Dua[2].

- The taxpayer was not the owner of the brands mentioned above, but had been providing specific services to the Indian companies. Therefore, the taxpayer could not be assessed for the above receipts as royalty when it was not the owner of the brands.

- Placing reliance on the judgment of the Bombay High Court in the case of NGC Networks Asia LLC[3], it was contended that since tax was deducted from the payment received by the taxpayer, the taxpayer was not liable to pay advance tax. Therefore, interest under section 234B of the Act would not be applicable.

Revenue's contentions:

- The taxpayer could not identify the expenses relating to any particular Indian hotel out of the marketing expenses incurred by it. Accordingly, relying on the decision of Chennai Tribunal, in the case of M/s Van-Oord ACZ Marine[4] , it contended that the taxpayer had not substantiated its claim that there was no profit mark-up in the bills raised against the Indian companies. There was no evidence on record to show that the market value of services received by the Indian companies were equivalent to the payments made. The reimbursement on a cost-to-cost basis or absence of the profit element were not deciding factors, and the tax authorities were required to see the objective for which the payments were received;

- The advertising programmes were not directed to any particular hotel but to the brand names, 'Marriott' and 'Renaissance'. There was no direct nexus between the Indian hotels and the expenses/ costs or providing the services. The Department Representative (DR), placing reliance on an identical issue in the ruling of Authority for Advance Ruling (AAR) in the case of International Hotel Licensing Company[5], contended that the amount received by a non-resident applicant from Indian hotels in connection with marketing and business promotion activities conducted outside India could not be treated as mere reimbursement of costs and expenses. The same would be taxable as FIS under section 9(1)(vii) of the Act;

- On the approval given by the Government of India, the DR contended that the said approval did not override the provisions of the Act as the conditions attached in that approval specifically provided that the agreement shall be subject to Indian laws;

- The DR submitted that the taxpayer's Group had bifurcated the royalty amount into different types of receipts only to suit its convenience. The taxpayer's Group was using the funds so collected in different names only to promote its brand name. Accordingly, the "form" should be ignored and the "substance" should be looked into;

- The ISMA and the agreement with MWC were inter-dependent. As such, the interconnected services rendered by two different companies should be considered as ideal in nature. The purpose or intention of

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[2] CIT *v.* Arun Dua [1989] 45 Taxman 246 (Calcutta HC)

[3] DIT *v.* NGC Networks Asia LLC [2009] 313 ITR 187 (Bombay HC)

[4] Van Oord ACZ Marine Contractors BV *v.* ADIT [2012] 23 taxmann.com 146 (Chennai-Tribunal)

[5] International Hotel Licensing Co., *In re* [2007] 288 ITR 534 (AAR)

the Marriott Group should be taken as the prime factor to decide the issue under consideration;

- Interest under section 234B of the Act was consequential in nature.

Tribunal's ruling:

The Tribunal observed as follows:

- The conditions attached to the permission given by the Government of India for remittance by the Indian companies specifically provided that the approval would be subject to Indian laws. Therefore, the taxpayer's contention that "the Government of India had accorded necessary permission to remit the payment on specific head and the tax authorities were not entitled to take a different view", was not correct.

- The responsibility to maintain the brand value lay with the brand owner. The brand value was maintained by continuous and sustained advertisement/ marketing activities. In the instant case, the Marriot and Renaissance brands were owned by one company (whose name and activities were not available on record). The ISMA had been entered into with another company, viz. the taxpayer. Since the taxpayer had collected the charges from the hotel carrying out the marketing activities, the Revenue had contended that the charges so collected should also be construed as a part of royalty only. Therefore, the amount received by the taxpayer company as reimbursement of expenses from the Indian hotels should be considered as royalty, since that amount had been spent on popularising the brand name, which would otherwise be the responsibility of the brand owner;

- The taxpayer's claim that it was undertaking the marketing work on a cost-to-cost basis defied logic and prudence. A commercial company would never work without profit. The very fact that it was functioning on a cost-to-cost basis proved that the taxpayer company was only an extended arm of the Marriott Group owning the brand name. Therefore, this was a clear tax planning by adoption of a "colourable device". Accordingly, the separate legal identity of the taxpayer got blurred, and the corporate veil had to be lifted. The amount received by the taxpayer had to be examined from the point of view of the original owner of the brand as the advertisement/ marketing programmes were carried out by the taxpayer in the name of Marriott and/ or Renaissance brand;

- Hence, all payments made by the Indian companies to the taxpayer went to swell the value of the existing brand names referred to above, and therefore had to be taxed as royalty in terms of Article 12 of the India-US tax treaty;

- The TO was directed to follow the Bombay High Court decision in NGC Networks Asia LLC[3] and delete the interest under section of section 234B of the Act.

The takeaway:

The Tribunal in this case has lifted the corporate veil and has held that services rendered by the taxpayer were for the overall development of the brands and hence is taxable as royalty. However, a reading of the order showed that the Authorised Representative for the taxpayer did not take recourse to the definition of 'make available' provisions of the India-US tax treaty when the Revenue contended that the payments ought to be taxed as FIS.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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