Tax Hotline

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NO WITHHOLDING TAX APPLICABLE ON ARBITRAL AWARD

- Holds that damages for breach of contract and interest thereon, paid in consequence of an international arbitral award, are not taxable in India under Article 22(1) of the Indo-Swiss DTAA;
- Re-affirms the principle that amounts paid pursuant to a court decree assume the character of a judgment debt and are not amendable to any deductions or adjustments (including tax deduction at source) absent specific provision in the Civil Procedure Code, 1908, the Income Tax Act, 1961, or the decree itself.

The Delhi High Court ("**Court**") in *Glencore International AG v. Dalmia Cement (Bharat) Limited*[1] has held that amounts paid to a non-resident pursuant to an international arbitration award would not be subject to withholding tax in India.

BACKGROUND AND FACTS

Glencore International AG ("**Glencore**"), a Swiss company, initiated international arbitration proceedings against Dalmia Cement ("**Dalmia**") for breach of contract[2] and received an award in its favour. The Award comprised of (i) damages for breach of contract; (ii) Glencore's legal costs, (iii) the costs of the arbitration proceedings and (iv) interest on all of the foregoing.

Dalmia objected to the enforcement of the award under section 48 of the Arbitration and Conciliation Act, 1996 ("**A&C Act**"). However, the Court dismissed the objections, and the dismissal was upheld by the Supreme Court.

The Court then passed a decree directing Dalmia to deposit the full amount of the award (INR 37,20,13,028) with the Court, and subsequently directed that a part (INR 20,20,22,530) of the award to be released to Glencore, and that the remainder (INR 16,99,90,498) be retained while the views of the Indian tax department were sought on whether Glencore was required to pay, and therefore Dalmia required to withhold, tax on the award.

In this background, Glencore approached the Court for the release of the balance amount of the award.

ISSUE

Whether Dalmia was required to withhold, tax on amounts paid pursuant to an international arbitral award, comprising *inter alia* damages for breach of contract and interest thereon.

ARGUMENT OF THE TAX DEPARTMENT

The Tax Department sought to establish the underlying character of the various amounts comprising the award, in order to determine their taxability.

- *Damages for breach of contract*: The Tax Department argued that such amounts would constitute "income from other sources" in the hands of Glencore under section 56 of the Income Tax Act, 1961 ("**ITA**"). While conceding that amounts characterized as "Income from Other Sources" would likely fall to be dealt with under Article 22(1) (Other Income) of the Indo-Swiss Tax Treaty[3], which accords the right to tax Other Income primarily to the country of residence of the recipient, the Tax Department argued that due to the "windfall" nature of the amounts, they could fall within the exception under clause 3[4], opening up the possibility for India to exercise a right to tax. While a more precise determination would need to be carried out at the time of assessment, the Tax Department argued that it would be fair for tax be withheld at the rate of ~40%[5] until a final determination was reached by the assessing officer during an assessment.
- *Legal Costs and Arbitration Costs:* In spite of acknowledging that such amounts constituted reimbursements for costs incurred by Glencore, the Tax Department still recommended that tax be withheld on such amounts as if they had imbibed the same character as the payments for which they were intended to be reimbursements. The Tax Department argued for the amounts to be treated as fees for technical services, liable to withholding tax at the rate of 10% under Article 12 of the Indo-Swiss Tax Treaty.
- *Interest.* The Tax Department recommended a withholding tax of 10% on such amounts under Article 11 of the Indo-Swiss Tax Treaty.

RULING

The Court rejected the arguments of the Tax Department.

It held that amounts comprising damages for breach of contract, along with interest thereon would not fall within the exception to Article 22(1) of the Indo-Swiss Tax Treaty i.e., Article 22(3), and would therefore not be taxable in India.

It further held that the amounts comprising reimbursement of legal costs and arbitration costs could not be regarded

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as income of Glencore, and therefore would not be taxable in India.

Thus, having determined that the amounts would not be taxable in the hands of Glencore, it ruled that there was no requirement for Dalmia to withhold tax on the same.

ANALSIS

Indian taxation of damages for breach of contract typically depends on the nature and effect of the breach. Damages for breach of contract resulting in damage to a claimant's trading apparatus are usually characterized as capital receipts not subject to tax, while damages for breach of contract resulting in mere loss of revenue are usually characterized as revenue receipts, subject to tax.

In this ruling, although the Court did not address the character of the damages, it nevertheless held that they should be treated as "Other Income" under Article 22(1) of the Indo-Swiss Tax Treaty, and therefore not taxable in India. Importantly, the Court further held that the interest component of the award should also be treated as "Other Income" under Article 22(1) of the Indo-Swiss Tax Treaty, and not as "Interest" under Article 11.

The Court also rightly rejected the incredulous argument of the Tax Department that damages for breach of contract should be equated to "windfall" gains, akin to winnings from lotteries or horse races.

Interestingly, the Court, as *obiter dicta,* made reference to another judicial principle: that once an arbitral award acquires the status of a court decree, amounts payable thereunder acquire the status of a judgment debt. The judgment debt must be discharged by payment of the full amount due under the said decree, subject only to the deductions and adjustments expressly permissible under the Civil Procedure Code, 1908 ("**CPC**") or any other legislation, or the decree itself. Therefore, the question of withholding tax at source does not arise. The Tax Department is however free assess decree holders to tax in India, if they believe components or all of the awarded amounts should, for whatever reason, be subject to tax in India.

– Joachim Saldanha & Ashish Kabra
You can direct your queries or comments to the authors

[1] EX.P. 75/2015 & EX.APPL.(OS) Nos.1216-17/2015

[2] The breach was due to the non-acceptance of coal shipment delivery

[3] Article 22(1) of the Indo-Swiss Tax Treaty provides that items of income not dealt with in the foregoing articles of the Treaty shall be taxable only in the State of residence of the recipient.

[4] Clause (3) of Article 22 provides that notwithstanding Article 22(1), if a resident of a State derives income from sources within the other State in the form of lotteries, crossword puzzles, races including horse races, card games and other games of any sort or gambling or betting of any form or nature whatsoever, such income may be taxed in that other State.

[5] Foreign Companies are subject to tax in India at the rate of 40%, unless a lower rate is prescribed.

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