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No disallowance can be made for belated TDS remittances applying non-discrimination article under the tax treaty

Background

Recently, the Chennai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Cooper Standard Automotive India Pvt. Ltd.[1] (the taxpayer) held that no disallowance can be made under Section 40(a)(i) of the Income-tax Act, 1961 (the Act) for belated Tax Deducted at Source (TDS) remittances on payment of professional charges and corporate maintenance charges applying non-discrimination article under the respective tax treaties[2].

The Tribunal held that payment for server maintenance charges are not in the nature of Fees for Technical Services (FTS) in the absence of human element. Only actual costs are recovered by the parent company from group company and there was no profit element involved in such operations. The payment was for reimbursement of expenses and hence tax was not required to be deducted under Section 195 of the Act.

The Tribunal also held that the payment for testing and development charges is in the nature of FTS and it is taxable under the Act as well as under the India-Italy tax treaty. The Tribunal observed that the services are rendered outside India and utilised in India. The Explanation to Section 9(2) of the Act was introduced in 2007 with retrospective effect from 1976 and the Assessment Year (AY) under consideration is AY 2003-04, the taxpayer cannot predict the amendment and deduct tax which is an impossible task. Therefore, such payment for the services rendered outside India are not taxable under Section 9(1)(vii) of the Act.

Facts of the case

Payment for professional charges and corporate management charges

- During the AY 2003-04, the taxpayer has made payment for professional charges and corporate management charges after deducting TDS under Section 195 of the Act. However, payment for TDS was remitted to the Government of India beyond the due date specified under Section 200(1) of the Act. The Assessing Officer (AO) made the disallowance under 40(a)(i) of the Act. The Commissioner of Income-tax (Appeals) [CIT(A)] confirmed the disallowance made by the AO.

Payment for server maintenance charges and testing and development charges

- The taxpayer had made the payment for server maintenance charges for the usage access of the server belonging to the parent company based at Germany. All the activities of parent company as well as subsidiary companies based around the world are routed through the server. According to the taxpayer, the server maintenance charges are in the nature of reimbursement charges paid to parent company using software related issues and hence TDS is not applicable.

- The AO made addition holding that services rendered outside India is taxable, even though there is no Permanent Establishment (PE) in India. By virtue of amendment to the Explanation of Section 9(2) of the Act, the FTS payable outside India would be deemed to accrue or arise in India and hence TDS is deductible.

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[1] Cooper Standard Automotive India Pvt Ltd v. ACIT (ITA No. 785/Mds/2014) – Taxsutra.com

[2] India-Germany tax treaty, India-U.K. tax treaty

- Similarly, the taxpayer also paid testing and development charges to Hutchinson Italy for the services rendered in the vendor location in Italy. However, no tax was deducted on such payment under Section 195 of the Act. Therefore, the AO made the addition under Section 40(a)(i) of the Act. Subsequently, the CIT(A) confirmed the addition made by the AO.

- The auto components of power steering system consisting of three hoses 'suction line, pressure line, and return line' are tested for various parts. The taxpayer manufactures the said parts according to drawing and specifications and designs of the company and subsequently sent to vendor location in Italy for testing on their efficiency and strength.

- The taxpayer contended that the testing was largely done on machines with very little of human judgment or skill. The only skill required was knowledge to operate the machine and to take readings. The only task of non-resident was to give a report on the performance of component by giving actual values based on readings and design specifications.

Tribunal's ruling

Payment for professional charges and corporate management charges – Amendment made by the Finance Act, 2003 in Section 40(a)(i) of the Act

- The provisions of Section 40(a)(i) of the Act as stood prior to amendment by the Finance Act, 2003 prescribe the disallowance for non-deduction or non-payment. The Proviso to the said Section provides that where the tax has been deducted but paid in any subsequent year, the same will be allowed as deduction in the year in which tax has been paid or deducted. The Circular No. 7, dated 5 July 2003 referred by the taxpayer also states the same. Therefore, for allowing the deduction of the expenditure, not only deduction of tax at source but also remittance to the government account is a mandatory requirement. The Proviso to Section 40(a)(i) of the Act makes it very clear that expenditure is allowed in the year in which the tax has been remitted to government account. Thus, the taxpayer is entitled for claiming the expenditure in the year in which it was paid.

- In the taxpayer's case, though the tax was deducted but remitted to the government account in the subsequent year. Therefore, the AO has rightly applied the disallowance under Section 40(a)(i) of the Act.

Payment for professional charges and corporate management charges – Applicability of non-discrimination clause

- In the case of Millennium Infocom Technologies Ltd.[3] the Delhi Tribunal has held that similar payments in the case of residents does not attract the disallowance in the event of non-deduction of tax at source. Thus, taxing the amount under Section 40(a)(i) for non-deduction of tax at source on similar amounts tantamount to discrimination. Therefore, the tax treaty and the decision relied on by the taxpayer for non-discrimination clause squarely applicable in the taxpayer's case. Accordingly, it has been held that the disallowance under Section 40(a)(i) of the Act would not be applicable in the case of the taxpayer.

Server maintenance charges

- The server maintenance charges are paid for usage of intranet, internet, mail data backup, etc., located at Germany. The server is administered by parent company and the activities support the periodical data backup, software upgradation and renewal, inter-office communication like messenger and communicator etc.

- On perusal of various decisions[4], the FTS involve human element and consideration is for rendering the managerial, technical and consultancy services. Therefore, applying the rule of *noscitur a sociis* the word 'technical' as appearing in Explanation 2 to Section 9(1)(vii) of the Act would also have to be construed as involving human element.

- However, facility provided by the parent company in the case of server maintenance charges was the usage of various activities and no human interface is involved. The only actual costs are recovered by the parent company from group constituents and there was no profit element.

- From the facts of the present case, it is observed that the taxpayer is merely using the technology provided by the parent company and no managerial, consultancy and technical services are provided by the parent company. Therefore, it has been held that the payment made is not for FTS and the decisions relied upon by the taxpayer are squarely applicable in the taxpayer's case. Therefore, it has been held that the payment was for reimbursement of expenses and hence no tax is deductible under Section 195 of the Act as held by the Tribunal in the case of Cairn Energy Pvt. Ltd.[5].

Testing and development charges

- The activity of testing, operating of the machine and noting of actual reading, whether it suits to the design specifications or not is a specialised activity only a technical person can do but not the machines alone. The machine cannot discharge such functions and human expert knowledge only can decide whether the parts are acceptable or

[3] Millennium Infocom Technologies Ltd. v. ACIT [2009] 117 ITD 114 (Del)

[4] Siemens Ltd. v. CIT [2013] 142 ITD 1 (Mum), CIT v. Bharti Cellular Ltd. [2009] 319 ITR 139(Del)

[5] Cairn Energy Pvt. Ltd. v. ACIT [2010] 2 ITR 38 (Chennai)

not. Mere machine operator cannot decide whether the auto parts are as per the specifications and drawings or not. Therefore, the payment is made for technical services.

- The taxpayer contended that the services are rendered outside India and to tax the income under Section 9(1)(vii) of the Act the services should have been rendered in India and utilised in India. The Explanation to Section 9(2) of the Act was introduced in 2007 with effect from 1976 and the AY under consideration is 2003-04, the taxpayer cannot predict the amendment and deduct the TDS which is an impossible task.

- The payment was made for FTS and it is taxable under the Act and the tax treaty. However, the services are rendered outside India and utilised in India. As per the decision of Supreme Court in the case of Ishikawajima Harima Heavy Industries[6] it is clarified that despite the deeming fiction in Section 9, for any such income to be taxable in India, there must be sufficient territorial nexus between such income and the territory of India. It further held that for establishing such territorial nexus, the services have to be rendered in India as well as utilised in India.

- The Explanation to Section 9(2) of the Act was introduced by the Finance Act, 2007 with effect from 1976 and as on the date of assessment there was no provision to tax the FTS rendered outside India and hence it has been held that no tax is deductible under Section 195 and consequent disallowance is not called for. This view is supported by the Mumbai Tribunal in the case of Channel Guide India Ltd.[7]

- Therefore, it has been held that the payment made by the taxpayer for FTS for the services rendered outside India are not taxable under Section 9(1)(vii) of the Act and the disallowance was to be deleted.

Our comments

Non-discrimination article in tax treaties obligate the contracting states to prevent a less favourable taxation to the residents of other states, and can be broadly categorised based (i) on nationality based discrimination (ii) on PE based discrimination (iii) discrimination based on status of payee and (iv) ownership based discrimination. In the present case, the Chennai Tribunal was dealt with third category of non-discrimination.

The Delhi Tribunal in the case of Herbalife International India (P.) Ltd.[8] held that the provisions of Section 40(a)(i)[9] provided for disallowance of payment made to a non-resident only where tax is not deducted at source on such payment at source. A similar payment to a resident does not result in disallowance in the event of non-deduction of tax at source. Thus, a resident left with a choice of dealing with a resident or a non-resident in business, would opt to deal with a resident rather than a non-resident owing to the provisions of Section 40(a)(i) of the Act. To that extent, the non-resident is discriminated. Article 26(3) of India-USA tax treaty seeks to provide against such discrimination and provides that deduction should be allowed on the same condition as if the payment is made to a resident. Thus, this clause under the tax treaty neutralises the rigour of the provisions of Section 40(a)(i) of the Act. Therefore, the AO cannot invoke the provisions of Section 40(a)(i) to disallow the claim of the taxpayer for deduction even on the assumption that the sum in question was chargeable to tax in India. Subsequently, the Tribunal[10] while following the ratio of the Delhi Tribunal held on similar lines.

The Finance Act (No.2) 2014 has amended Section 40(a)(ia) of the Act. The amended Section provides disallowance on account of failure to deduct tax at source shall be restricted to 30 per cent of the amount of expenditure in case of payments made to a resident. Such an amendment has also resulted into discrimination between resident and non-resident since clause (i) of Section 40(a) which deals with non-resident has not been correspondingly amended to provide for a similar reduced disallowance.

The present decision may help the cases of non-residents where disallowance has been made in a similar situation.

With respect to the payment made prior to the retrospective amendment, the Tribunal in some of the cases[11] has held that the retrospective amendment made under the Act was not in existence when the taxpayer made payments to a foreign company. Therefore, disallowance under Section 40(a)(i)/40(a)(ia) of the Act could not be made.

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[6] Ishikawajima-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)
[7] Channel Guide India Ltd. v. ACIT [2012] 25 taxmann.com 25 (Mum)
[8] Herbalife International India (P.) Ltd. v. ACIT [2006] 101 ITD 450 (Del)
[9] As it existed prior to its amendment by Finance Act, 2003

[10] DCIT v. Incent Tours (P.) Ltd [2012] 53 SOT 308 (Del), Sandoz (P.) Ltd v. ACIT [2010] 42 SOT 450 (Mum), Central Bank of India v. DCIT [2012] 148 TTJ 237 (Mum), Mitsubishi Corporation India (P.) Ltd v. ACIT [2010] 38 SOT 158 (Chen)
[11] United Helicharters Pvt. Ltd. v. ACIT [2013] 37 taxmann.com 343 (Mum), Metro & Metro v. ACIT [2014] 147 ITD 207 (Agra)

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala,
Bengaluru – 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh – 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai – 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Gurugram
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurugram, Haryana – 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
Reliance Humsafar, 4th Floor
8-2-618/2, Road No.11, Banjara Hills
Hyderabad – 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Jaipur
Regus Radiant Centres Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road
Jaipur, Rajasthan, 302018.
Tel: +91 141 - 7103224

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091
Tel: +91 33 4403 4000
Fax: +91 33 4403 4199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai – 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park
Tower-B, Plot# 7, Sector 142,
Expressway Noida, Gautam Budh Nagar,
Noida – 201305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex, Mundhwa Road,
Ghorpadi, Pune – 411001
Tel: +91 20 6747 7000
Fax: +91 20 6747 7100

Vadodara
iPlex India Private Limited,
1st floor office space, No. 1004,
Vadodara Hyper, Dr. V S Marg
Alkapuri, Vadodara – 390 007
Tel: +91 0265 235 1085/232 2607/232 2672